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Many attorneys are unaware of or misunderstand an important tool they can use to protect their business organization clients: the ability to disclose the client's confidences. In jurisdictions with "loyal disclosure" rules—rules adopted by the Securities and Exchange Commission and the American Bar Association in response to Enron and other corporate scandals—counsel may disclose confidential information to protect an entity client from the harmful, illegal conduct of company constituents. In this essay, I explain that an entity client has an interest in its attorneys understanding these complicated rules and, when appropriate, disclosing confidences to protect the organization from the financial consequences of constituent misconduct.

In contrast to adverse disclosure rules that allow attorneys to divulge confidences to protect a third party or the lawyer,[1] loyal disclosure rules permit counsel to disclose confidences to protect the entity client itself. The text of loyal disclosure rules is complex, but these rules essentially provide that disclosure is permitted if counsel is certain that constituents are engaged in illegal conduct and reasonably believes substantial injury to the organization can be averted through disclosure.[2] Imagine that an attorney represents Renron Corporation. Renron's managers are breaching their fiduciary duties to the corporation. They are defrauding the investing public. Counsel knows that if the managers are not stopped the company will suffer substantial financial injury. Counsel has presented these concerns to a committee of disinterested

1. MODEL RULES OF PROF'L CONDUCT R. 1.6(b) & cmts. 6-15 (2003).

2. 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2008); MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2003). Twenty-four states have adopted Model Rule 1.13(c) or a substantially similar provision.

directors, but the directors refuse to act. Loyal disclosure rules permit counsel to reveal otherwise confidential information to save Renron.

While there is some logic in this loyal disclosure scenario, it highlights a number of practical problems with the rules. I can easily create a fictitious lawyer who knows with certainty that his or her business client's constituents are engaged in illegal conduct that will harm the company. But it is much more difficult for a real lawyer, looking at isolated facts in the present, to draw such conclusions. Lawyers may believe determinations of "fraud" and "breach of fiduciary duty" should only be made by juries (after months of testimony that follow years of discovery) and not by lawyers. Further, in the Renron example, I simply assume that disclosure could have saved the company. In practice, however, it may be hard to conceive that divulging client confidences (to the SEC, for example) would be in the client's interest. In sum, a lawyer faces a difficult task when considering loyal disclosure. Not only must the lawyer determine if he or she has the requisite certainty that the entity client's business conduct is illegal and likely to injure the company, but he or she also must determine whether disclosure will protect rather than harm the client.

Given the difficulty of reaching such conclusions, attorneys may be relieved to learn that the SEC and ABA loyal disclosure rules provide that attorneys "may" (but not "shall") disclose confidences to protect the entity client.[3] Some lawyers may conclude that the question of loyal disclosure can be avoided by exercising this discretion to maintain the business client's confidences.

Nonetheless, lawyers should not dismiss loyal disclosure rules as impossibly complex or as merely permissive. Attorneys have ethical and legal obligations as fiduciaries to act in the best interest of their entity clients when client constituents are engaged in illegal conduct. Counsel should be guided by two principles in this regard. First, the attorney's duty is to the entity.[4] Second, it is in the entity's best interest to avoid financial injury arising from constituent misconduct.[5] Attorneys have faced civil liability for not protecting their organizational clients from such misconduct.[6] Before the promulgation of loyal disclosure rules, attorneys were barred from taking protective measures

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3. 17 C.F.R. § 205.3(d)(2)(i) & (iii); MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2003).

4. *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, 600 (1998).

5. *See* Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 736-37 (2004).

6. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 96 cmt. f (2000) (citing cases where attorneys were held liable for not taking steps to protect organizational clients from wrongful conduct of constituents).

that would violate the duty of confidentiality.[7] But in jurisdictions that have removed this prohibition by adopting loyal disclosure rules, a fiduciary should no longer err on the side of confidentiality but must instead critically analyze his or her client's interest in disclosure.

When an attorney is concerned that company constituents are engaged in illegal activity, there is an important prerequisite to loyal disclosure: "up the ladder" reporting. Up the ladder reporting rules require counsel to report evidence of illegal conduct to increasingly higher levels of authority in the organization, including if necessary, the organization's highest authority.[8] These rules broadly define the types of illegal conduct that a company's attorney must report,[9] thus inviting lawyers to scrutinize company conduct for fraud, breaches of fiduciary duty, securities law violations, and similar transgressions. Attorneys who endeavor to make these tough determinations and take their conclusions up the ladder will provide their clients with the advice needed to correct misconduct and avoid financial injury.

When the company's highest authority fails or refuses to respond appropriately to up the ladder reporting, a lawyer should evaluate the propriety of loyal disclosure. Under the loyal disclosure rules, counsel must have a high level of certainty that the conduct is illegal.[10] Such certainty may be present in cases where the material facts are not in dispute (as when client constituents have made admissions to counsel) or when only one reasonable conclusion can be drawn from the facts known to counsel. Attorneys must then consider whether they reasonably believe disclosure to someone could protect the client from substantial financial injury, such as by preventing future illegal conduct. While the SEC rule only allows disclosure to the SEC, the ABA rule does not limit the recipients of loyal disclosure.[11] In jurisdictions that follow the ABA

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7. Stephen Gillers, *Model Rule 1.13(c) Gives the Wrong Answer to the Question of Corporate Counsel Disclosure*, 1 GEO. J. LEGAL ETHICS 289, 289 (1987).

8. 17 C.F.R. § 205.3(b), (c) (2008) (explaining the duty to report "evidence of a material violation" to higher authorities in the corporation, and defining the company's highest authority for such a report as the audit committee, a committee of disinterested directors, or a qualified legal compliance committee); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003) (describing an attorney's duty to report to higher authorities, and if necessary to the organization's "highest authority," when the attorney "knows" that a constituent is engaged in a legal violation to the organization or a legal violation that might be imputed to the organization).

9. 17 C.F.R. § 205.2(i) (2008); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003).

10. 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2008) (allowing loyal disclosure of a "material violation" and not "evidence" of a material violation); MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2003) (permitting loyal disclosure of conduct that is "clearly a violation of law").

11. 17 C.F.R. § 205.3(d)(2)(i) & (iii) (providing for disclosure "to the Commission"); MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2003).

rule, an obvious candidate for loyal disclosure is a nonmanagement owner: a partner, limited partner, member, or shareholder who otherwise would be unaware of the conduct in question.[12] An owner may be able to spur management to action when the company's lawyer could not.

If counsel determines loyal disclosure is appropriate to protect the organization from substantial injury, counsel should explain this conclusion to the company's highest authority—the same individuals who received the lawyer's up the ladder report. Counsel's suggestion of imminent loyal disclosure will likely create an adversarial relationship between these managers and counsel. And perhaps it should. Attorneys and managers *are* adversaries when managers refuse to address counsel's report that constituents are engaged in illegal conduct that will harm the company's financial interests. Decisions that create legal liability for the organization are not "business decisions," and lawyers should not defer to managers on these matters.[13] In jurisdictions that prohibit loyal disclosure, counsel has no option other than resignation if managers do not take corrective action. On the other hand, when counsel has the ability to take the additional step of disclosure, company decisionmakers may be more inclined to correct illegal conduct, obviating the need for disclosure.[14] Under either scenario—lawyer disclosure or corrective conduct by managers—the organization will be better protected from the adverse financial consequences of illegal constituent conduct.

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12. Paula Schaefer, *Overcoming Noneconomic Barriers to Loyal Disclosure*, 44 AM. BUS. LAW J. 417, 459-64 (2007).

13. MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 3 (2003).

14. *See* AM. BAR ASS'N, TASK FORCE ON CORPORATE RESPONSIBILITY REPORT 55 (2003).