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Law Firms Must Disclose Current Conflict of Interest, But May Still Be Entitled to Fees for Services After Failure To Do So

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Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc., No. S232946, 2018 Cal. LEXIS 6399 (Aug. 30, 2018).

Brief Summary

After a law firm was disqualified from representing a defendant in a *qui tam* lawsuit because it represented one of the plaintiffs in unrelated matters (despite having an advance waiver), the firm sued defendant for the unpaid portion of its fees. After lengthy proceedings, including an arbitration award later set aside by the Court of Appeal, the California Supreme Court held that an engagement agreement, including its arbitration clause, was unenforceable on public policy grounds where there was a concurrent conflict of interest that was known and not disclosed at the time of the engagement, but remanded to the trial court to determine whether the law firm would be entitled to any fees on a *quantum meruit* basis.

Complete Summary

In early 2010, Sheppard, Mullin, Richter & Hampton LLP ("Sheppard Mullin") agreed to take over the representation of J-M Manufacturing ("J-M") in a federal *qui tam* suit brought against J-M on behalf of over 200 public entities for the alleged sale of faulty PVC pipes. Sheppard Mullin ran a conflict check and found that another Sheppard Mullin attorney in a different office had represented one of the plaintiffs, South Tahoe Public Utility District ("South Tahoe"), in unrelated employment matters on and off since 2002, and most recently in November 2009. Because South Tahoe had signed an advance conflict waiver in matters unrelated to the employment matters, Sheppard Mullin concluded that it could take on the representation of J-M. Sheppard Mullin and J-M entered into an engagement agreement that recited the terms of the agreement, and included a current and advance conflict waiver, but did not refer to the representation of South Tahoe. The engagement agreement also provided for arbitration for any dispute arising under the agreement.

After J-M engaged Sheppard Mullin, the law firm did about 12 hours of work for South Tahoe. In 2011, South Tahoe discovered Sheppard Mullin's representation of both parties and filed a motion to disqualify Sheppard Mullin in the *qui tam* action. The district court granted the motion, ruling that the

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simultaneous representation was undertaken without adequately informed waivers in violation of rule 3-310(C)(3) of the California Rules of Professional Conduct (the "Rules").

Sheppard Mullin had incurred nearly $3.8 million in fees in representing J-M and over $1 million was outstanding when it was disqualified. Sheppard Mullin filed a lawsuit for the unpaid fees and sought specific performance of the arbitration provision in their agreement. J-M filed a cross-complaint for breach of contract, breach of fiduciary duty, fraudulent inducement, and sought disgorgement of previously paid fees and exemplary damages. The trial court granted Sheppard Mullin's request to compel arbitration. The arbitrators ruled in favor of Sheppard Mullin, noting that the conflict of interest did not: cause J-M damage, did not prejudice J-M's defense in the *qui tam* action, did not result in communication of J-M's confidential information to South Tahoe, and did not render Sheppard Mullin's representation less effective or valuable to J-M. Sheppard Mullin petitioned to confirm the award and J-M petitioned to vacate it on the basis that the engagement agreement was unenforceable due to the violation of Rule 3-310(C)(3). The trial court confirmed the award, citing California precedent. The Court of Appeal reversed holding that the matter never should have been arbitrated because Sheppard Mullin's undisclosed conflict violated the Rules and rendered the engagement agreement with J-M unenforceable and disentitled it to fees from J-M while it represented South Tahoe in other matters. Sheppard Mullin appealed.

The California Supreme Court addressed three issues:

1. Can a court invalidate an arbitration award on the grounds that the agreement, including the arbitration provision, violates public policy as expressed in the Rules rather than in statutory law?
2. Was there a violation of the Rules?
3. Does such a violation automatically disentitle the law firm from compensation?

The Court first determined that a court has the authority to invalidate an arbitration award on public policy grounds on the basis of a violation of the Rules. The Court explained that the premise of prior California cases, specifically including *Loving & Evans v. Blick*, is that an agreement to arbitrate is invalid and unenforceable because it violates public policy even though the public policy is not enshrined in a legislative enactment. The California State Bar is authorized by statute to formulate the rules, which are then adopted with the approval of the state's high Court. "The rules 'are not only ethical standards to guide the conduct of members of the bar; but they also serve as an expression of public policy to protect the public.'" The Court determined that a violation of the Rules in the forming of the engagement agreement made the entire agreement, including the arbitration provision, unenforceable—noting that it would be absurd for a court to help an attorney enforce a transaction prohibited by the Rules.

The Court found that the Rules had been violated, not because of the advance waiver (the court took no position on the advance waiver), but because the concurrent representation of J-M and South Tahoe was not disclosed. Sheppard Mullin knew it represented South Tahoe at the time of the J-M engagement and failed to inform J-M. Therefore, J-M's consent in the conflict waiver was not "informed," and according to the Court, this failure affected the whole agreement, rendering it unenforceable in its entirety. Even though Sheppard Mullin was not working on a particular matter for South Tahoe when the firm was engaged by J-M, the Court reasoned that the work described in the South Tahoe engagement letter (employment matters) was of an ongoing nature, rendering it a current client. Further, the conflict waiver was invalid because it merely alerted J-M that a conflict *might* exist, but not that one *actually* existed. Significantly, because the Court viewed the issue as a failure to disclose a current conflict of interest, it did not decide whether—and under what circumstances—an advance waiver would be permissible.

Finally, the Court concluded that the ethical violation did not categorically disentitle the law firm from recovering the value of its services to J-M, and remanded to the trial court to permit Sheppard Mullin to demonstrate whether equitable principles entitled the law firm to some measure of compensation for the services provided to J-M. The Court noted that there was no California law that established a bright-line rule barring all compensation for services performed subject to an improperly waived conflict.

Two dissenting justices thought that the conduct was egregious enough that Sheppard Mullin was not entitled to any fees.

Significance

The ruling is significant for what it addressed and what it did not. It did not generally address whether an advance waiver is enforceable in California. It did, however, make it clear that attorneys must disclose known conflicts and that a violation of Rules can render a contract unenforceable in its entirety on public policy grounds.

As an ancillary matter, firms should ensure whenever possible that their engagement letters make clear when a representation will end to avoid having an inadvertent "current" client.

For more information please contact Cassidy Chivers

Pursuant to the engagement agreement, the arbitration clause was governed by the California Arbitration Act (Cal. Code Civ. Proc. §1282 *et seq*), not the Federal Arbitration Act, and the case was decided under the California Act.
Moncharsh v. Heily & Blase, 3 Cal.4th 1 (1992).
Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., Inc., 244 Cal. App. 4th 590, 198 Cal. Rptr. 3d 253, 2016 Cal. App. LEXIS 69 (Cal. App. 2d Dist., Jan. 29, 2016).
The Court's decision is 42 pages with a 24-page dissent.
Citing to the standard set forth in *Loving & Evans v. Blick*, 33 Cal.2d 603 (1949).
Loving & Evans v. Blick, 33 Cal.2d 603 (1949).
Citing to *Altschul v. Sayble* (1978) 83 Cal.App.3d 153, 163.
Citing to *Chambers v. Kay*, 29 Cal.4th 142 (2002).