

The Lawyers' Lawyer Newsletter

Lawyers for the
Profession®



Recent Developments in Risk Management

October 2018 | Volume 23 | Issue 4

Conflicts of Interest – Advance Waivers – Requirements for Waivers of Existing Conflicts – Proper Forum to Determine Arbitrability of Disputes – Scope of Fee Disgorgement When Attorneys Violate Fiduciary Duties to Clients

Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., Inc.
(Aug. 30, 2018, No. S232946) ___ Cal.5th___ (2018 Cal. LEXIS 6399)

Risk Management Issues: What are the requirements for obtaining waivers of existing conflicts? Does a client's sophistication matter when considering disclosure of a concurrent conflict? Is it possible to draft a viable advance waiver of potential conflicts? Are suits for fees ever appropriate?

The Case: On March 4, 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. J-M faced an exposure of over \$1 billion in damages. Sheppard Mullin's conflict check revealed that another Sheppard Mullin attorney in a different office previously 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 non-employment matters, Sheppard Mullin concluded that it could take on the representation of J-M. The engagement agreement between Sheppard Mullin and J-M was negotiated, and while J-M's general counsel revised certain portions of the agreement, she made no changes to the conflict waiver provision. Moreover, the provision did not refer specifically to South Tahoe. Sheppard Mullin did not tell J-M about its representation of South Tahoe before or at the time the engagement agreement was signed. The engagement agreement provided for arbitration of any dispute arising under the agreement.

The waiver provision provided:

Conflicts with Other Clients. Sheppard, Mullin, Richter & Hampton LLP has many attorneys and multiple offices. We may currently or in the future represent one or more other clients (including current, former, and future clients) in matters involving [J-M]. We undertake this engagement on the condition that we may represent another client in a matter in which we do not represent [J-M], even if the interests of the other client are adverse to [J-M] (including appearance on behalf of another client adverse to [J-M] in litigation or arbitration) and can also, if necessary, examine or cross-examine [J-M] personnel on behalf of that other client in such proceedings or in other proceedings to which [J-M] is not a party provided the other matter is not substantially related to our representation of [J-M] and in the course of representing [J-M] we have not obtained confidential information of [J-M] material to representation of the other client. By consenting to this arrangement, [J-M] is waiving our obligation of loyalty to it so long as we maintain confidentiality and adhere to the foregoing limitations. We seek



Hinshaw's Safety Net® is built to support law firm general counsel or corporate in-house counsel and contains a comprehensive set of research materials related to **legal ethics**, **professional responsibility** and **law firm risk management** within a **secure** and **confidential** system. To get more information on this on-line tool, click **here**.

this consent to allow our Firm to meet the needs of existing and future clients, to remain available to those other clients and to render legal services with vigor and competence. Also, if an attorney does not continue an engagement or must withdraw therefrom, the client may incur delay, prejudice or additional cost such as acquainting new counsel with the matter.

After J-M engaged Sheppard Mullin, the firm billed South Tahoe for about 12 hours of work. 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 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 billed 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; prejudice J-M's defense in the *qui tam* action; result in communication of J-M's confidential information to South Tahoe; nor did it 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). While the trial court confirmed the award, the Court of Appeal reversed, holding that the matter never should have been arbitrated because Sheppard Mullin's undisclosed concurrent conflict violated the Rules and rendered the engagement agreement with J-M unenforceable and disentitled it to any fees from J-M while it represented South Tahoe in other matters. Sheppard Mullin appealed.

The California Supreme Court affirmed in part, and reversed and remanded in part. The court agreed that Sheppard Mullin's failure to inform J-M of its attorney/client relationship with South Tahoe constituted a conflict of interest that rendered its engagement agreement with J-M unenforceable as against public policy. However, it also ruled, contrary to the Court of Appeal, that the ethical violation does not categorically disentitle the law firm from recovering the value of its services under a *quantum meruit* theory.

Comment 1: Although the court called South Tahoe a "dormant client," Sheppard Mullin worked (albeit less than 20 hours) for the client in the preceding year. Unfortunately for the firm, the amount of hours worked was irrelevant to the court's analysis concerning whether South Tahoe was a current or former client, because, as explained below, the representation had not been terminated and thus there was a reasonable expectation that it was ongoing at the time J-M retained the firm.

In California, Rule 3-310(C)(3) prohibits the concurrent representation of adverse parties, even if the subject matters of the respective representations are substantially unrelated. This is because the rule's paramount concern is grounded in the duty of loyalty, not confidentiality. Sheppard Mullin did not dispute this general premise, but rather argued that it had properly obtained both clients' informed written consent by way of the conflict waiver in both clients' engagement agreements.

The Court rejected this argument because J-M's consent could not have been "informed" where Sheppard Mullin concealed the identity of a known, current client, and thus an *actual* conflict. "Informed written consent" is defined to mean 'written agreement to the representation following written disclosure,' and 'disclosure' is defined as 'informing the client . . . of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences to the client . . .'" *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., Inc.* (Aug. 30, 2018, No. S232946) ___ Cal.5th___, 2018 Cal. LEXIS 6399, at 19.

The undisclosed "relevant circumstance" was the firm's relationship with South Tahoe, which J-M characterized as a "present reality" at the time of the engagement with J-M, and the firm characterized as a "former" or "dormant" attorney-client relationship. The court agreed with J-M. In so holding, it examined the terms of the engagement between Sheppard Mullin and South Tahoe:

South Tahoe's operative engagement agreement, executed in 2006, provided that Sheppard Mullin would represent the utility district "in connection with general employment matters (the 'Matter')." The agreement further provided that South Tahoe could terminate the representation at any time, as could Sheppard Mullin (subject to its ethical obligations), but that otherwise the representation would terminate "upon completion of the Matter" unless the firm agreed to render other legal services to the agency. **The parties' agreement thus established an attorney-client relationship that, absent earlier termination by one of the parties, would endure so long as Sheppard Mullin continued to work on "the Matter," which was defined in the agreement as "general employment matters."**

(Emphasis added).

Thus, although the work for South Tahoe was sporadic between 2002 and 2009 and, presumably, there was no work pending on March 4, 2010 when J-M retained the firm, by *operation of the South Tahoe engagement agreement*, the representation had not ended. The broadly defined scope of work—“general employment matters”—meant that the relationship could not automatically terminate by completion of the assignment under the agreement. And, neither party instigated the termination provision. The court also rejected Sheppard Mullin’s argument that its arrangement with South Tahoe was akin to a “framework” agreement under which “the relationship would be renewed, on the same terms, each time the client had a new assignment for the firm—and, critically, one that would end when the assignment was completed.” The court said:

[The] terms of the agreement do not, however, bear out the characterization. The agreement provided that Sheppard Mullin’s representation of South Tahoe would continue for the length of “the Matter,” which the agreement defined as general employment matters, in the plural. The definition belies the suggestion that the parties intended to terminate the attorney-client relationship after each individual general employment matter was completed. And unlike the framework agreement . . . the agreement contained no language reserving to the law firm the right to decline work requested by the client. Nor did the agreement include any other explicit statement that Sheppard Mullin and South Tahoe would maintain an attorney-client relationship only during times when the law firm was actually performing work for the utility district.

Accordingly, the court concluded that although the engagement agreement was not a true retainer (i.e., where a retainer is paid for access to the firm), “it was not a simple framework agreement, either. It was, rather, an agreement governing a continuing engagement involving occasional work on employment matters as needed. . . . **Absent any express agreement severing the relationship during periods of inactivity, South Tahoe could reasonably have believed that it continued to enjoy an attorney-client relationship with its longtime law firm even when no project was ongoing.**”

Comment 2: The sophistication of the client is immaterial where a known conflict exists and is undisclosed. Sheppard Mullin and various amicus curiae argued that many corporate clients (such as J-M) are large and sophisticated with bargaining power equal to or exceeding that of the firm. Such clients, and in particular their general counsel, understand and accept that large national and international firms may currently or in the future represent clients with potentially conflicting interests, but the firms can maintain loyalty and confidentiality to both clients.

Sheppard Mullin asserted that J-M was clear-eyed about its risks and agreed to accept them when entering into the engagement agreement containing the blanket conflict waiver. The court rejected this notion simply because Sheppard Mullin knew of the existing and conflicting relationship with South Tahoe and did not disclose it. “By asking J-M to waive current conflicts as well as future ones, Sheppard Mullin did put J-M on notice that a current conflict *might* exist. But by failing to disclose to J-M the fact that a current conflict *actually* existed, the law firm failed to disclose to its client all of the ‘relevant circumstances’ within its knowledge relating to its representation of J-M.” Thus, “[i]f a conflict of interest is known to an attorney at the time he seeks a waiver, the attorney is not allowed to hide that conflict, regardless of whether the client is sophisticated or not.”

In short, the client’s level of sophistication does not come into play if there is an actual conflict to disclose. “No matter how large and sophisticated, a prospective client does not have access to a law firm’s list of other clients, and cannot check for itself whether the firm represents adverse parties. Nor can it evaluate for itself the risk that it may be deprived, via motion for disqualification, of its counsel of choice, as happened here. In any event, clients should not have to investigate their attorneys. Simply put, withholding available information about a known, existing conflict is not consistent with informed consent.”

Comment 3: The Court did not reject the use of advance conflicts waivers in future cases under the revised California Rules of Professional Conduct; but law firms should tread carefully. The Court sidestepped whether advance waivers – where the clients waive potential conflicts in advance – comply with the Rules, stating: “Because this case concerns the failure to disclose a current conflict, we have no occasion here to decide whether, or under what circumstances, a blanket advance waiver . . . would be permissible.” Nevertheless, the court addressed the comprehensive amendments to California’s Rules of Professional Conduct approving, in part, language from rule 1.7 of the Model Rules regarding conflicts. In footnote 7, the court said that with respect to advance conflict waivers, “the client’s experience and sophistication and the presence of independent representation in connection with the [informed] consent are ‘relevant’ to the effectiveness of that consent, and that the new rule ‘does not preclude an informed written consent [] to a future conflict in compliance with applicable case law.’” The court also stated in footnote 9 that “[s]everal federal courts applying California law have declined to enforce blanket advance waivers on grounds they insufficiently disclosed the conflicts of interest.” Citing *Lennar Mare Island, LLC v. Steadfast Ins. Co.* (E.D.Cal. 2015) 105 F. Supp. 3d 1100, 1115, 1118; *Western Sugar Coop. v. Archer-Daniels-Midland Co.* (C.D.Cal. 2015) 98 F. Supp. 3d 1074, 1083–1084; *Concat LP v. Unilever, PLC* (N.D.Cal. 2004) 350 F. Supp. 2d 796, 801, 819–821.

In the cases cited, the courts were highly critical of open-ended waivers. For instance, in *Western Sugar Coop.*, the court concluded the waiver was too open-ended, non-specific, and lacked identification of potentially adverse clients, the types of conflicts, or the types of possible future representations. The court went further in *Lennar*, rejecting the ABA's "broader interpretation" of informed consent. The *Lennar* court commented that "California has adopted neither ABA Model Rule 1.7 nor its comments. Its policy . . . encompasses a broader range of concerns that goes beyond the client's sophistication or the absence of a direct and substantially related conflict." And, in *Concat*, even if a prospective waiver of conflict has been obtained, the attorney must request a second, more specific waiver, "if the [prospective] waiver letter insufficiently disclosed the nature of the conflict that subsequently arose between the parties." The *Concat* court explained that unless the initial waiver included a specific disclosure of the law firm's concurrent representation of another client, together with a clear description of how the two concurrent client relationships might, in future, give rise to conflict, a second waiver would need to be obtained.

Hinshaw & Culbertson LLP

151 North Franklin Street
Suite 2500, Chicago, IL 60601
312-704-3000
www.hinshawlaw.com
www.lawyringlaw.com

Editors:

Anthony E. Davis and Noah D. Fiedler

Contributor: Cassidy E. Chivers

Risk Management Solutions: (1) This holding illustrates the tension between a firm's business instincts to secure and maintain a client relationship, and its risk management interests. The most conservative risk management solution here would have been to utilize a framework agreement as described by the court, or separate agreements for each assignment, so that the client does not have a reasonable expectation of an uninterrupted attorney-client relationship. Of course, the countervailing risk is that the client does not perceive the relationship as long-term, and shops for a new firm. However, the best way to mitigate that risk is to simply do good work for the client. Another risk management solution is to be diligent about close-out and termination communications. Lawyers and law firms should review their files for "dormant" clients and send termination letters to avoid inadvertent conflicts of interest and potential disqualification. See *M'Guinness v. Johnson* (2015) 243 Cal.App.4th 602: <https://www.hinshawlaw.com/newsroom-updates-Client-Agreement-and-Failure-to-Terminate-Representation-Under-the-Terms-of-Client-Agreement-Results-in-Firms-Disqualification-Under-Concurrent-Representation-Rule.html>

(2) The silver lining of the court's ruling here is that it is unequivocal. A blanket waiver does not satisfy the requirement that a firm obtain "informed written consent" of a conflict where the identity of the adverse client and the subject matter of the adverse representation are not disclosed. The client's level of sophistication is irrelevant, so lawyers and law firms should not rely on it for deciding whether or not to seek a waiver, and therefore deciding to disclose existing conflicts.

(3) As noted above, the California Supreme Court in *Sheppard Mullin* acknowledged that it had approved certain language from Model Rule 1.7 and that the sophistication of the client may be a factor in determining whether an advance conflict waiver will pass muster. At the same time, the court pointed out that both the current rule 3-310 and new rule 1.7 require "informed written consent for concurrent representation of adverse interests." It remains to be seen whether California courts will gravitate toward the ABA's broader interpretation of informed consent under the new rule. However, in this case, the court seems to be sending a strong message that the courts should abide by the same elevated standards articulated in the federal court decisions cited in footnote 9. As such, practitioners should continue to follow the approach in *Concat*: (1) include a specific disclosure of the concurrent client and a specific description of the potential future conflict; or (2) utilize a broad advance waiver but obtain a second waiver immediately once a conflict becomes reasonably clear.

Hinshaw & Culbertson LLP prepares this newsletter to provide information on recent legal developments of interest to our readers. This publication is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. *The Lawyers' Lawyer Newsletter* is published by Hinshaw & Culbertson LLP. Hinshaw & Culbertson LLP is a U.S. law firm with 450 attorneys located in 11 states and London. Founded in 1934, the firm has a national reputation for its insurance industry work, its representation of professionals and law firms, and its closely coordinated business advisory, transactional and litigation services. We serve clients

ranging from emerging and middle-market businesses to Fortune 500 companies, as well as governmental and public sector clients. For more information, please visit us at www.hinshawlaw.com.

Copyright © 2018 Hinshaw & Culbertson LLP, all rights reserved. No articles may be reprinted without the written permission of Hinshaw & Culbertson LLP, except that permission is hereby granted to subscriber law firms or companies to photocopy solely for internal use by their attorneys and staff.