Supreme Court Case No. S232946

IN THE SUPREME COURT

OF THE STATE OF CALIFORNIA

SHEPPARD, MULLIN, RICHTER & HAMPTON, LLP,

Plaintiff and Respondent,

v.

J-M MANUFACTURING CO., INC.,

Defendant and Appellant.

Court of Appeal, Second Appellate District, Division Four
Case No. YC067332

San Bernardino County Superior Court/Central Justice Center
Case No. CIVDS 1108273
Honorable Stuart Rice, Judge

J-M MANUFACTURING COMPANY, INC.'S CONSOLIDATED ANSWER TO AMICUS BRIEFS

GREINES, MARTIN, STEIN & RICHLAND LLP
Kent J. Richland, State Bar No. 51413
Jeffery E. Raskin, State Bar No. 223608
5900 Wilshire Boulevard, 12th Floor
Los Angeles, California 90036
Telephone: (310) 859-7811 ⌇ Facsimile: (310) 276-5261
Email: krichland@gmsr.com
jraskin@gmsr.com

Attorneys for Defendant and Appellant
J-M MANUFACTURING COMPANY, INC., dba J-M EAGLE

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5900 Wilshire Boulevard, 12th Floor
Los Angeles, California 90036
Telephone: (310) 859-7811 ⌊ Facsimile: (310) 276-5261
Email: krichland@gmsr.com
jraskin@gmsr.com

Attorneys for Defendant and Appellant
J-M MANUFACTURING COMPANY, INC., dba J-M EAGLE

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

TABLE OF AUTHORITIES

Page(s)

CASES

RULES AND STATUTES

TABLE OF AUTHORITIES

RULES AND STATUTES

TABLE OF AUTHORITIES

RULES AND STATUTES

TABLE OF AUTHORITIES

OTHER AUTHORITIES

INTRODUCTION

The amicus briefs supporting the two parties here depict two starkly different versions of the reality confronting clients when they hire lawyers.

The amici supporting Sheppard—large law firms, their insurance companies, a group of law professors and an association representing discipline defense counsel—insist that their thirst for generalized, open-ended conflict waivers is motivated by nothing more than a desire to protect their clients. They insist that sophisticated clients or those with in-house counsel have more than sufficient bargaining power to negotiate out of such waiver provisions. (E.g., Liability Insurers' Brief, pp. 5-15; Law Firms' Brief, p. 11; Discipline Defense Counsel Brief, pp. 4-9.) In fact, the large law firms go so far as to claim that the "only reasonable inference" that can be drawn from some clients agreeing to such waivers is that clients don't mind conflicts: They claim that clients are "indifferent to who is adverse" to them, do not want the "disrupti[on]" of having to read and consider disclosures, or actually want to hire firms with conflicted interests. (Law Firms' Brief, pp. 17, 19.) Amici thus implore that courts must "[a]llow clients to opt out of" receiving pesky disclosures of the relevant facts and to treat the waiver of an attorney's duty of loyalty as a simple arm's-length business deal. (*Id.* at p. 10.)

By contrast, amici supporting J-M—institutional clients consisting of business entities and the Association of Corporate Counsel—share their actual experience. They explain that they care deeply about having the

opportunity to consider factual disclosures that bear on their attorneys' conflicts of interests, but they often have no real choice but to agree to general, open-ended waivers. The expressed desires and experience of the clients themselves belie the claims of Sheppard's amici that their desire for this Court's approval of broad, non-specific, open-ended conflict waivers is rooted in their concern for client welfare and suggests a harsher, if far more plausible, reality:

First, the large law firms have such a hefty appetite for general, open-ended conflict waivers because it allows them to grow their profits without the mess of obtaining conflict waivers as conflicts arise, and the ever-present risk that they will lose business because the existing client will not agree to waive the conflict once apprised of the relevant facts. It is no small surprise that it has historically been the large law firms that have sought to modify ethics rules to allow general, open-ended advance conflict waivers. (E.g., Buckner, *Addressing the Intricacies of Future Conflict Waivers* (2008) 50-NOV Orange County Law. 46, 47["intensive lobbying efforts by large law firms" drove the California Bar's initial examination of advance conflict waivers].) And the sheer numbers of large law firms appearing as amici on behalf of Sheppard only confirms the significance of the issue to them.

Second, while there may be some clients that have the bargaining strength to negotiate out of such waivers, most are not so fortunate. That a client has in-house counsel does not make it a "bargaining heavyweight[]," as amici put it. (See Law Firms' Brief, p. 11.) Most

clients are not that large. Most are not that powerful. And most do not carry the promise of so great a volume of potential work that they can tempt law firms to abandon their desire for general, open-ended conflict waivers. As some of the amici supporting J-M explain, they have personally been forced to sign such waivers because the law firms demanded they do so, and they needed the law firm because of its particular expertise in the type of case they were confronting. (E.g., Exponential Interactive, et al. Brief, pp. 2-8, 11, 15-16; Assn. Corporate Counsel Brief, pp. 4, 12.)

Indeed, the Law Firm amici expose the extremes to which they want to push California's rules of ethics—far beyond anything resembling even the ABA Model Rules. For instance:

- They see nothing wrong with a prospective attorney telling a prospective client there are "no conflicts" even though the attorney's conflict check revealed one. (Law Firms' Brief, p. 7, fn. 1.) The Law Firms say this is permissible because it is supposedly "accepted usage for lawyers, and courts, to use the words 'no conflicts' when they mean 'no unwaived conflicts.'" (*Ibid.*) That can't possibly be right. When a *prospective* client inquires about the existence of any undisclosed conflicts *before* the prospective client waives conflicts, the undisclosed conflicts are by definition "unwaived conflicts." Besides, under every ethical regime, the attorney is obligated to disclose the known conflict, whether or not the client asks.

- The Law Firms apparently envision a world in which even unsophisticated clients can be made to sign generalized, open-ended advance conflict waivers. The ABA Model Rules absolutely prohibit this. (ABA Model Rules, rule 1.7, com. 22.) But the law firm amici are only willing to say that "truly unsophisticated clients who do not have the benefit of independent counsel *may* need more disclosure" than what Sheppard Mullin provided here, which is *no* disclosure at all. (Law Firms' Brief, p. 5, italics added.)

In this brief, we explain that, contrary to the assumption of Sheppard's amici, the only issue presented here is the validity of a general, open-ended conflict waiver where the attorney *knows* of a present or imminent conflict but fails to tell the prospective client of the facts relevant to that conflict—a practice permitted in no jurisdiction. We then explain why Sheppard's amici's policy reasons seeking to justify that practice have no validity whatsoever.

This argument, however, is bookended by a brief discussion of two other issues touched upon by two of Sheppard's amici. First, we address whether California law requires a court or an arbitrator to determine the issue of whether an entire contract is unlawful. As we explain, for decades this Court and the lower appellate courts have clearly held that the issue of entire contract illegality *must* be decided by the courts—principally because that's the system the Legislature designed. Thus, even if amici's policy arguments had merit (as we show, they do not), it is the Legislature, not this Court, that is the proper forum for any change. Second, we address

whether California law requires the client to prove harm arising from such an undisclosed conflict of interest and whether any disgorgement or forfeiture of fees must be proportionate to that proven harm. As we explain, there is no justification for such a rule, which would operate solely to allow attorneys to take advantage of what authorities uniformly recognize is a circumstance in which the extent of damages is, for all practical purposes, impossible to prove, but in which the client unquestionably did not receive what it bargained for.

ARGUMENT

I. UNDER WELL-ESTABLISHED CALIFORNIA LAW, COURTS—NOT ARBITRATORS—MUST DETERMINE ENTIRE-ILLEGALITY CHALLENGES TO A CONTRACT THAT CONTAINS AN ARBITRATION PROVISION.

As J-M's Answer Brief demonstrated, a long line of decisions of this Court and the intermediate appellate courts firmly establishes the rule in California that where, as here, a party challenges the entire illegality of a contract containing an arbitration provision, that challenge must be decided by a court—not an arbitrator. (J-M Answer Brief, § I.) The Amici Law Firms contrary arguments are wholly without merit.

First, the Law Firms rely on *Gueyffier v. Ann Summers, Ltd.* (2008) 43 Cal.4th 1179, 1182, for the proposition that "'[a]bsent an express and unambiguous limitation in the contract,'" arbitrators have broad authority to grant any relief "rationally related" to their factual findings and contractual interpretation, and they assert the arbitrators therefore had the authority to find that Sheppard Mullin acted in good faith and was entitled to compensation. (Law Firms' Brief, pp. 7, 9.) But *Gueyffier* was concerned with the scope of arbitral powers of contract interpretation and had nothing to do with the question of the appropriate forum for determining the issue of whether a case should go to arbitration in the first place—much less whether the contract containing the arbitration provision is entirely illegal. "'It is axiomatic, of course, that a decision does not stand for a proposition

not considered by the court.'" (*Agnew v. State Bd. of Equalization* (1999) 21 Cal.4th 310, 332.)

Moncharsh v. Heily & Blase (1992) 3 Cal.4th 1 and its progeny are clear that an arbitrator has no power to decide any issue if the arbitration provision is contained in an entirely illegal contract—a determination that courts must make de novo before compelling arbitration. (J-M Answer Brief, § I.) Where, as here, the entire contract is illegal as against public policy, no court could enforce it by compelling arbitration, the dispute was not arbitrable, and the arbitrators' factual findings and award therefore lacked any force. Similarly, the Law Firms' contention that parties are entitled to rely on the benefits of an arbitration agreement (Law Firms' Brief, p. 6) makes no sense when the arbitration provision is in a contract that is *entirely* illegal; no party has the right to rely on any part of a contract that is so violative of public policy that it is entirely unenforceable.

Second, the Law Firms worry that "[i]f J-M's position were to be accepted, a client could conceivably await the result of an arbitration and then, if the result is unpalatable, seek to relitigate *de novo* what the arbitrators had already decided by claiming 'illegality.'" (Law Firms' Brief, p. 9.) Not so. *Moncharsh* itself guarantees that such fear is baseless: Parties cannot contest entire-illegality unless they "raise the illegality question prior to participating in the arbitration process." (*Moncharsh*, *supra*, 3 Cal.4th at pp. 30-31 [discussing "'procedural gamesmanship'"]; see J-M Answer Brief, p. 16.) And J-M did exactly that here. (Opinion, pp. 8-9 [trial court argument and writ petition].)

Third, amici note that a contract is only entirely illegal if it has a "'single object, and such object is unlawful.'" (Law Firms' Brief, p. 6, quoting Civ. Code, § 1598.) They argue that engagement agreements have many lawful objects—the various terms and conditions under which the attorney will provide legal services—regardless of the legality of the conflict waiver provision. (*Id.* at pp. 6-7.) This argument seems deliberately obtuse. Every contract has terms and conditions. But it is undeniable that the single, overarching object of an engagement agreement is the creation of an attorney-client relationship. Sheppard Mullin's acceptance of the representation under the engagement agreement here—the document that created the attorney-client relationship—itself violated law and public policy because Sheppard Mullin withheld the information necessary to obtain J-M's informed consent. (Rules of Professional Conduct, rule 3-310(C).) That illegality permeated everything, including the various terms of the engagement agreement that defined the minutiae of the illegal relationship. Those other terms served no independent object. In short, the type of violation of the duty of loyalty committed by Sheppard Mullin struck at "the very foundation of an attorney-client relationship" and thus vitiated the entire agreement that purported to create that relationship. (See Opinion, pp. 11, 22-26.)

Fourth, the Law Firms urge this Court not to create a rule that lawyer-client arbitration clauses are unenforceable whenever a violation of an ethical rule is alleged. (Law Firms' Brief, p. 6.) No one has ever suggested such a thing. While the Law Firms assert that unconscionable

fees or an incident of lawyer "fraud" during a representation can implicate the duty of loyalty, such violations generally are not enough to render the *entire contractual relationship* illegal. If a fee is unconscionably high, the relationship itself remains lawful and the attorney is entitled to only reasonable compensation for his services. If a lawyer commits some types of "fraud" during a representation, the relationship itself remains lawful and the attorney must pay damages caused by the single unlawful act. None of these are comparable to the fundamental ethical violation that rendered the entire relationship invalid here.[1]

What's more, no one has ever suggested that an arbitration provision within an engagement agreement is unenforceable whenever a conflict rule has been "alleged" to have been violated. (*Ibid.*) The trial court must *determine* whether the contract is entirely illegal before denying a petition to compel arbitration. (Code Civ. Proc., §§ 1281, 1281.2; J-M Answer Brief, pp. 12-13 [trial court must deny arbitration when "grounds exist for the revocation" of the agreement].)

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[1] The Court of Appeal remanded so that the trial court could determine whether the conflict already existed or came into existence three weeks later because that is relevant to the scope of disgorgement. The United States District Court has already examined the evidence and held that South Tahoe was an existing Sheppard client at the time Sheppard undertook the J-M representation, finding Sheppard's contrary argument "unpersuasive" and not supported by "any evidence." (2AA347-348, 405.) But either way, the public policy problem existed from the beginning because Sheppard Mullin accepted the representation without obtaining J-M's informed consent to an existing or imminent conflict.

Fifth, the Law Firms express various concerns about the expense that will be generated in cases like J-M's:

- The Law Firms argue that in "many instances," courts will conclude that some issues are arbitrable, resulting in multiple litigations in different forums. (Law Firms' Brief, p. 8.) Not true. If the entire agreement containing the arbitration provision is illegal, then there is no enforceable arbitration agreement on which to premise an arbitration. In any event, the Law Firms are wrong to suggest that it would strike "at the core of the State's public policy" to sever arbitrable and non-arbitrable claims. (*Ibid.*) The Legislature provided for precisely such circumstances. (Code Civ. Proc., §§ 1281.2, subd. (c) [establishing procedure if "court determines that there are other issues between the petitioner and the respondent which are not subject to arbitration"], 1281.4 [stays involving arbitrable and non-arbitrable claims].)

- It is not clear if the Law Firms are concerned that a trial court must undertake a full trial, with discovery, to determine whether a claim is arbitrable. If that is what they mean by "delay and increased expense" (Law Firms' Brief, p. 8), the burden is not nearly so great. Just like any other opposition to a petition to compel arbitration, the trial court resolves the issue in a summary proceeding. If the court denies arbitration, that determination is immediately appealable. (Code Civ. Proc., § 1294, subd. (a).) If the court compels arbitration, that determination is reviewable by discretionary writ or after confirmation of the award. (*State Farm Fire & Casualty v. Hardin* (1989) 211 Cal.App.3d 501, 506.)

- The Law Firms argue that "[w]hen a dispute is removed from arbitration to a court, the court needs to allow discovery, request briefs, hold a hearing and issue a reasoned decision." (Law Firms' Brief, p. 8.) That is true if they mean that this is the result if the trial court refuses to compel arbitration and the Court of Appeal affirms that determination. But that is the normal cost of litigation of any non-arbitrable claim. And of course, arbitration involves discovery, briefing and hearings as well.

And despite all of the Law Firms' attempted criticisms, they fail to wrestle with the fundamental fact that it is *the Legislature* that has devised the scheme by which courts must determine entire illegality while deciding whether to compel arbitration. (J-M Answer Brief, pp. 12-14.) As this Court and the lower appellate courts have recognized for decades, the approach is mandated by statute. (*Id.* at pp. 12-15.) If the Law Firms want to change the law, they should take up the matter with the Legislature. They can then address their policy arguments—which, as shown above, are of dubious value at best—to a body in a position to do something about it.

II. CONTRARY TO THE ARGUMENTS OF SHEPPARD'S AMICI, NEITHER CALIFORNIA LAW NOR THE LAW OF ANY JURISDICTION PERMITS THE TYPE OF UNINFORMED CONFLICT WAIVER SHEPPARD USED HERE.

A. Contrary To Sheppard's Amici's Claims, No Jurisdiction Permits General Waivers For Existing Or Imminent Conflicts.

The amici supporting Sheppard operate on the assumption that the ABA and other jurisdictions consider general, open-ended conflict waivers appropriate not just when the attorney has no knowledge about a possible future conflict, but even when a particular conflict already exists or the attorney is aware that a particular conflict is imminent. For instance, the Professional Liability Insurer Amici argue that non-specific, open-ended waivers are enforceable against "sophisticated" clients who sign an "advance *or* general waiver of conflict of interest." (Liability Insurer Brief, p. 11, italics added; see also *id.* at pp. 16-18.) That is not and cannot be the law. Not in California. Not anywhere.

As J-M's Answer Brief on the Merits demonstrated, the only type of "general" conflict waiver permitted anywhere is a general *advance* conflict waiver. (J-M Answer Brief, § II.A.) Thus, these authorities address the permissibility of general waivers only with respect to *advance* waivers and explicitly state that a general waiver *cannot* be used as a substitute for disclosure of existing or impending conflicts about which the attorney is

aware. (*Id.* at pp. 22-25.) Likewise, the authorities describe the policy reasons *unique to advance waivers* that they believe justify the use of general advance waivers for hypothetical future conflicts. (*Id.* at pp. 28-31.)

None of the amicus briefs actually attempts to *demonstrate* that the ABA, the Restatement or any authority anywhere permits general, open-ended waivers for existing or imminent conflicts known by the attorney. And the very notion clearly and directly conflicts with California Rule of Professional Conduct 3-310. (See § II.B.1., *post.*)

As demonstrated in J-M's Answer Brief on the Merits, in light of the facts of this case, this Court need decide nothing beyond the disclosure rules applicable to existing conflicts and imminent conflicts, because under either party's interpretation of the facts, this case fits into one of those two categories:

- J-M contends that South Tahoe was an existing client of Sheppard Mullin: South Tahoe's engagement agreement with Sheppard Mullin was not restricted to a particular matter or time. (2AA277.) Rather, it contemplated a continuous, uninterrupted lawyer-client relationship involving periodically recurring employment advice from Sheppard on an "as-needed" basis. (2AA278-279, 288-289; Opinion, p. 4.) Neither South Tahoe nor Sheppard Mullin acted to terminate the relationship (as the engagement agreement permitted only by following an express procedure), and both lawyer and client acted consistently with J-M's interpretation of

the engagement agreement as providing for a continuing attorney-client relationship permitting South Tahoe to ask, whenever it saw fit, for legal advice. (2AA290; Opinion, p. 4; see J-M Answer Brief, pp. 4-6.) Indeed, Sheppard stated that its conflict check identified South Tahoe as an "existing client" and confirmed the "'long-standing relationship between [South Tahoe] and our Firm'" for nearly a decade. (Opinion, pp. 4, 7; 2AA317, ¶ 5; see J-M Answer Brief, p. 6 & fn. 1.) Not surprisingly, the district court rejected Sheppard's "argument that South Tahoe was not its client at the time it took on representation of J-M" as "unpersuasive," not based on "any evidence" and contrary to Sheppard and South Tahoe's pattern of conduct. (2AA347-348, 405.)

- Sheppard Mullin contends that the conflict did not arise until a few weeks after J-M signed the engagement agreement and conflict waiver. (See J-M Answer Brief, pp. 24-25.) But under the undisputed facts, Sheppard's relationship with South Tahoe constituted at least an imminent conflict that Sheppard Mullin was required to disclose. After all, Sheppard Mullin *knew* that South Tahoe was a long-time client to which it gave periodic, as-needed legal advice under an engagement agreement that purported to create an attorney-client relationship. (See J-M Answer Brief, pp. 4-6 & fn. 1.) And Sheppard Mullin *knew* that South Tahoe returned every few months for another round of legal advice. (*Ibid.*) While Sheppard Mullin did not know precisely when South Tahoe would next return, the firm had every reason to believe that it would shortly resume active work for South Tahoe. This was not speculation about some

hypothetical unknown party adverse to J-M that might some day retain Sheppard Mullin.

As this Court is well aware, the State Bar is nearing completion of its new rule regarding advance waivers of hypothetical conflicts that might later arise. (See § II.B.5.a., *post.*) As explained above, this case indisputably does not involve that situation. Consequently, there is absolutely no reason for this Court to decide that issue now.

As we next explain, amici's various arguments do not justify a change in California law regarding the requirements of informed consent in the circumstances that *are* present here—where there is a known conflict that either presently exists or is imminent.

B. Amici's Arguments Do Not Justify The Enforcement Of Broad, Open-Ended, General Waivers For Existing Conflicts, Imminent Conflicts, Or True Advance Conflicts.

1. Rule 3-310 does not permit general waivers of all undisclosed conflicts.

Rule 3-310 is clear. It requires "informed written consent" following "written disclosure" that informs the client of both "the *relevant circumstances* and of the actual and reasonably *foreseeable adverse consequences*" of any conflict of interest. (Italics added.) The rule ensures that the client receives vital information so that the client can evaluate the likelihood, nature, and degree of a conflict and decide whether it is in its

best interests to retain the attorney. Without such disclosure, the prospective client lacks the necessary information to make an informed decision—information known to the prospective attorney. Thus, the rule alleviates the fundamental information asymmetries facing the prospective client.

It is beyond question that an attorney fails to disclose the "relevant circumstances" of an existing or impending conflict if an attorney—knowing of an existing or imminent conflict—says only that he "*may*" have a conflict now or in the future, as Sheppard did here. (1AA201, italics added.) Such a general "disclosure" in reality discloses *no* "relevant circumstances" whatsoever.

Amicus Association of Discipline Defense Counsel takes a different view, but it can do so only by refusing to confront Rule 3-310's actual language. It contends the rule is only concerned with whether the client is aware of "what the client is actually agreeing to" and that sophisticated clients can easily understand "what the language of the waiver plainly says . . . ." (Discipline Defense Counsel Brief, pp. 11, 13-14.) Not so. Informed consent requires "written disclosure" of the "relevant circumstances" of a conflict and reasonably foreseeable risks—not just a client who is capable of intelligently reading a waiver that makes no disclosures whatsoever.

Likewise, contrary to what the Association of Discipline Defense Counsel argues, requiring the identification of an existing or highly likely

conflict known by the attorney does not improperly "elevate[] one factor" over other factors such as the client's sophistication. (*Id.* at p. 12.) Rule 3-310 requires disclosure of the "relevant circumstances" of a conflict, which at the very least requires the identification of the existence or likelihood of a particular conflict. It may be true that sophisticated clients with in-house counsel require *less detailed* disclosures in order to understand a disclosed conflict's scope and foreseeable adverse consequences. For instance, unlike a lay client, a sophisticated client's in-house counsel can better understand legal terminology that another attorney uses to describe a conflicting representation and can better appreciate the magnitude of such a representation. And once a particular conflict has been disclosed, in-house counsel might be in a better position to appreciate the significance of that conflict and its potential risks without as detailed a disclosure about foreseeable adverse consequences. But nothing in Rule 3-310—or the law of any jurisdiction—permits the attorney to withhold information about the *fact* of an existing or impending likely conflict.

Indeed, a Sheppard-style waiver in a firm's form engagement agreement is tailor-made to confuse clients, particularly in-house counsel. In-house counsel are well aware that the law requires attorneys to disclose conflicts. Naturally, when no conflicts are disclosed, in-house counsel will assume that a form waiver provision in a form engagement letter that says a conflict "may" exist is merely a form that has not been tailored to the circumstances of the representation, and therefore would reasonably infer that no present or impending conflict exists at all. And that is all the more