Supreme Court Case No. S232946

SUPREME COURT
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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. B256314

Los Angeles Superior Court
Case No. YC067332
Honorable Stuart Rice, Judge

ANSWER TO PETITION FOR REVIEW

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INTRODUCTION

This is a case of lawyers behaving badly and trying to avoid the consequences of having done so. Here, lawyers sought to evade the most basic ethical duty—to be loyal and zealous advocates for their client. They focused entirely on the welfare of their own law firm instead of its clients, turning their fiduciary duty on its head. Perhaps some hypothetical case may present nuanced ethical issues, but this is not that case.

This case involves a straightforward ethical violation that goes to the very heart of the attorney-client relationship and therefore voids the contract between the parties: a law firm represented one of its clients in litigation against another client. Although its conflict check revealed this actual conflict, the law firm chose not to tell the litigation client that it was also representing an opposing party in other matters. It didn't breathe a word about the conflict to the litigation client until the opposing party sought (successfully) to disqualify the law firm from representing the litigation client. That's not a complicated ethical scenario; it's not even a close call.

Despite the law firm's handwringing over the Court of Appeal getting the decision wrong in this particular case, its Petition fails to meet either requirement for review: the need to secure uniformity of decision or to settle an important question of law. In short:

1. The Petition asserts that the Court of Appeal violated the rules governing the proper forum for determining whether a contract containing an arbitration provision is illegal. But the decision the Petition relies on, *Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1 (*Moncharsh*), unambiguously established two different rules. The one that applies here involves the purely judicial determination of whether a contract is *entirely* illegal and thus, whether the case should not have

been compelled to arbitration in the first place. The other standard, inapplicable here, applies when a *single provision* of the contract is challenged; that question must be determined by the arbitrator, subject to minimal judicial review. The Petition also argues that the Court of Appeal erred in finding that the contract at issue was illegal in its entirety. This is largely a new argument not raised in the Court of Appeal. In any event, the legal standard, properly applied by the Court of Appeal, is well-worn.

2. The Petition's second issue—the push by some large law firms to validate boilerplate, non-specific "advance" waivers of conflicts of interest—fares no better. Whatever the general merits of such "advance waivers" (and we submit they are dubious), there is and can be no doubt that a client—in advance or otherwise—cannot without knowing the relevant facts waive a direct, actual, existing conflict of interest known to the attorney. Such a waiver completely undermines the attorney's loyalty to the client. There is simply no plausible argument—much less legal authority—that by generic, obscure, amorphous language, a law firm can knowingly hoodwink clients into waiving actual conflicting loyalty duties. In any event, the Court of Appeal's decision did not undermine all advance conflict waivers—just those, as here, involving undisclosed, known conflicts of interest. To the extent that the Petition urges this Court to broadly change the ethical rules regarding advance conflict waivers, the proper process is not judicial fiat, but the quasi-legislative, rule-making process—a process that recently considered but declined to make changes in the ethical rules governing conflicts of interest.

3. That leaves the Petition's claim that attorneys need not disgorge ill-gotten fees obtained when acting under an actual conflict of interest that undermines their duty of loyalty. The established law is otherwise. There's no conflict or important unresolved question of law presented.

The Court of Appeal made clear that it was applying established law. And so it was. The Petition challenges the Court of Appeal's application of that established law, but that's not a ground for review. Review should be summarily denied.

RELEVANT BACKGROUND

A. The Law Firm Discovers—And Conceals—Its Actual Loyalty Conflict In Simultaneously Representing J-M And South Tahoe.

J-M Manufacturing Company, Inc. (J-M) approached Sheppard Mullin to defend J-M in a federal qui tam action. (Opn., pp. 3-4.)

Sheppard Mullin ran a conflict check and discovered that the firm represented South Tahoe, an adverse party in the qui tam action. (Opn., pp. 2, 4.) For many years, Sheppard Mullin had provided South Tahoe with labor and employment advice on an ongoing, as-needed basis. (Opn., p. 4; 2 AA 288.)

The Sheppard Mullin partners responsible for the J-M litigation did not inform J-M or South Tahoe what their conflict check revealed. (Opn., p. 4.) They claimed they thought it was unnecessary because Sheppard Mullin had not performed any actual work for South Tahoe in the past five months and South Tahoe had signed an engagement letter that broadly waived conflicts. (*Ibid.*) They did not even mention the issue to Jeffrey Dinkin, the Sheppard Mullin partner responsible for South Tahoe. (2 AA 278-280, ¶¶ 13-14, 17.) Instead, "Sheppard Mullin attorneys assured [J-M] there were no conflicts in representing J-M in the Qui Tam Action." (Opn., p. 5.) They then provided J-M with an engagement agreement that purported to waive Sheppard Mullin's duty of loyalty regarding all "current, former, and future clients" that Sheppard Mullin "may" currently have or later obtain. (*Ibid.*) Sheppard Mullin never discussed or explained the conflict waiver provision or told J-M about its relationship with South Tahoe. (*Ibid.*)

B. South Tahoe Raises The Conflict; The Law Firm Still Says Nothing To J-M And Tries To Pay South Tahoe To Waive The Conflict.

Just three weeks after J-M signed the engagement letter, Sheppard Mullin resumed active work for South Tahoe. (Opn., p. 6.) It continued actively working for South Tahoe for a full year. (2 AA 278-279.) Still, Sheppard Mullin did not advise either client (or even Dinkin) about the conflict. (2 AA 280; Opn., p. 18.)

A year later, South Tahoe discovered the truth and demanded that Sheppard Mullin disqualify itself from simultaneously representing J-M and South Tahoe. (Opn., p. 6.) Sheppard Mullin still did not inform J-M of the issue for another fifty days. (*Ibid.*)

Ultimately, Sheppard Mullin tried to buy its way out of the conflict. In a letter to South Tahoe, it acknowledged that it had "'provide[d] labor advice to you for the last 9 years.'" (Opn., p. 7.) It offered to "'promptly pay to [South Tahoe] the sum of $100,000'" and to provide free "'legal advice and services'" if South Tahoe would "'consent to the Firm's continued representation of J-M in the pending federal district court action and any other state or federal action that [South Tahoe] and J-M may be involved in.'" (*Ibid.*) South Tahoe declined. (*Ibid.*) Sheppard Mullin upped the offer to $250,000, but South Tahoe continued pressing for disqualification. (Opn., pp. 7-8.)

The district court granted South Tahoe's motion to disqualify Sheppard Mullin. (Opn., p. 8.) The court rejected the firm's argument that it could unilaterally drop South Tahoe as a client, noting that a published decision in another case had previously rejected Sheppard Mullin's attempt to use that very tactic. (Opn., p. 7.)

C. Trial Court And Arbitration Proceedings.

Sheppard Mullin sued J-M for $1.3 million in unpaid legal fees arising from the qui tam action. (Opn., p. 8.) J-M cross-complained for various remedies, including disgorgement, based on both contract and tort theories. (*Ibid.*)

Over J-M's objection, the trial court compelled the case to arbitration. (Opn., p. 8.) J-M had opposed arbitration, arguing that the entire engagement agreement was illegal and void as against public policy. (*Ibid.*) The Court of Appeal summarily denied J-M's writ petition for interlocutory relief, and the parties proceeded to arbitration. (Opn., p. 9; see *State Farm Fire & Casualty v. Hardin* (1989) 211 Cal.App.3d 501, 506 [order compelling arbitration not immediately appealable].)

The trial court ultimately confirmed the arbitrators' award in favor of Sheppard Mullin. (Opn., p. 10.)

D. Court Of Appeal Decision Applying Established Law.

The Court of Appeal reversed, explaining that each step of its multi-step analysis followed existing California law. (Opn., pp. 2-3, 12-15, 17, 19-22, 26-29.)

First, the court recognized that under well-established California law, a challenge to the legality of an entire contract that contains an arbitration provision must be determined by the court rather than the arbitrator. (Opn., pp. 2, 12-15.) While judicial review of an arbitration decision is typically limited to the statutory grounds for vacatur, established principles require courts to determine the legality of the entire contract de novo. (Opn., pp. 11-16.) The decision quoted and discussed the unambiguous language of multiple Supreme Court and Court of Appeal cases and Witkin, which all repeat the same rule. (*Ibid.*, quoting *Moncharsh, supra*, 3 Cal.4th 1, *Loving & Evans v. Blick* (1949) 33 Cal.2d 603 (*Loving*), *Ahdout v. Hekmatjah* (2013) 213 Cal.App.4th 21 (*Ahdout*), *Lindenstadt v.*

Staff Builders, Inc. (1997) 55 Cal.App.4th 882 and 1 Witkin, Summary of Cal. Law (10th ed. 2005) Contracts, § 450, p. 490.) The same authorities make it clear that challenges to the entire contract must be treated differently than challenges to only a portion of the contract, since if the entire contract is illegal, "the arbitration clause would not be enforceable" whereas the illegality of a portion of a contract is an arbitrable issue. (Opn., pp. 13-15, quoting *Moncharsh, supra*, 3 Cal.4th at pp. 29-32.)

Next, the Court of Appeal determined that under the particular facts here, Sheppard Mullin violated the rules of professional responsibility by failing to disclose the conflict with South Tahoe. (Opn., pp. 16-22.) It held that this violation rendered the entire engagement agreement unenforceable because the duty of loyalty presents a public policy of "paramount concern"—the preservation of public trust in the administration of justice and in the integrity of the Bar—that strikes at "the very foundation of an attorney-client relationship" created by the engagement agreement and permeates the contract relationship. (Opn. pp. 22-26.) The Court explained that public policies created by a variety of sources, including the rules of professional responsibility, can invalidate contracts as a whole. (Opn., pp. 22, 24-26.)

Finally, the Court of Appeal held that Sheppard Mullin's ethical violation precludes it from recovering compensation for its services and entitles J-M to disgorgement of fees previously paid. (Opn., pp. 26-30.) The Court again expressly applied existing California law that had "drawn a line between cases involving serious ethical violations such as conflicts of interest, in which compensation is prohibited, and technical violations or potential conflicts, in which compensation may be allowed." (Opn., p. 26.) The Court rejected Sheppard Mullin's argument that prior cases required a showing that the client had suffered damages from the attorney's misconduct; no such showing is required in cases of

direct conflicts, as opposed to mere technical violations of conflict rules. (Opn., pp. 28-29.)

The Court of Appeal remanded for a determination of whether the actual conflict existed at the beginning of the J-M engagement or emerged three weeks later, when Sheppard Mullin resumed active work for South Tahoe. (Opn., pp. 30-31.)

The Court of Appeal denied Sheppard Mullin's rehearing petition.

ARGUMENT: THERE IS NO GROUND FOR REVIEW

Review is appropriate only when "necessary to secure uniformity of decision or to settle an important question of law." (Cal. Rules of Court, rule 8.500(b)(1).) Neither ground exists here. The Court of Appeal simply applied well-established law—often, law repeatedly pronounced by this Court—to the particular facts here. There is no conflict or any need to clarify an unsettled issue.

I. THERE IS NO IMPORTANT QUESTION OF LAW TO RESOLVE.

A. The Law Regarding Challenges To The Legality Of An Entire Contract Containing An Arbitration Provision Is Well Established.

The Petition claims that the Court of Appeal created a "new rule" for reviewing arbitration cases in which a party challenges the contract's overall legality. (Petition, pp. 8-13.) Not so.

The Court of Appeal followed well-established law regarding review of a claim that the *entire contract* is illegal. The rule that the Petition relies on applies only to the illegality of a *single provision.* (Opn., pp. 2, 12-16.) That distinction is well settled by multiple pronouncements of this Court and other courts, as recognized by Witkin.

1. The established rule: The legality of the entire contract is for the court—not for arbitrators; when a court decides that issue, it is not reviewing an arbitration award.

This Court has repeatedly held that the legality of the *entire* contract is a purely judicial determination—not one for arbitrators. Courts must undertake that analysis *before*, and as part of, ordering the case to arbitration.

This Court could not have been more clear in *Moncharsh*: "If a contract includes an arbitration agreement, and grounds exist to revoke the entire contract, such grounds would also vitiate the arbitration agreement. Thus, if an otherwise enforceable arbitration agreement is contained in an illegal contract, a party may avoid arbitration altogether." (*Moncharsh, supra*, 3 Cal.4th at p. 29, citing Code Civ. Proc., § 1281.2.)

"By contrast," when "the alleged illegality goes to *only a portion of the contract* (that does not include the arbitration agreement), the entire controversy, including the issue of illegality, remains arbitrable." (*Moncharsh, supra,* 3 Cal.4th at p. 30, italics added.) In those circumstances, the parties must submit the illegality issue to the arbitrator, and the courts can only narrowly review the arbitrator's determination. (*Id.* at p. 32.)

In fact, this Court recognized the same distinction decades earlier in *Loving, supra*, 33 Cal.2d 603. Again, the Court was crystal clear that the legality of the entire transaction is an issue for judicial determination. (*Id.* at pp. 609-610.) "The question of the validity of the basic contract being essentially a *judicial* question, it remains such whether it is presented" in a proceeding to compel arbitration or to vacate an award. (*Id.* at p. 610, italics added.) If presented during a proceeding to compel arbitration, the court should deny arbitration if the contract is entirely illegal. (*Ibid.*) And if presented during a proceeding to vacate the award, the award

must be vacated for excess of power, because if the case was not arbitrable, the arbitrator had no power to make any decision whatsoever. (*Ibid.*) Even if the arbitrator decides the issue of legality of the entire transaction, that issue is still "one for judicial determination upon the evidence presented to the trial court, and any preliminary determination of legality by the arbitrator, whether in the nature of a determination of a pure question of law or a mixed question of fact and law, should not be held to be binding upon the trial court." (*Id.* at p. 609.)

The rule is so well established that Witkin repeats it. (1 Witkin, Summary of Cal. Law, *supra*, Contracts, § 450, p. 490.)

The issue on appeal here was the trial court's initial order compelling arbitration and its reaffirmation of that order in refusing to vacate. *Both* orders were reviewable in the appeal from the final judgment. (*State Farm Fire & Casualty v. Hardin, supra,* 211 Cal.App.3d at p. 506.) J-M raised the "entire illegality" issue in opposing both the petition to compel arbitration (Opn., pp. 8-9) and the petition to confirm (Opn., p. 10). Thus, there is no question that the appeal here went to the illegality of the entire contract—by challenging the *trial court's* pre-arbitration determination granting the motion to compel and its post-arbitration reaffirmation of that ruling.

Unbroken precedent holds that those are judicial issues for *courts*, trial and appellate, to decide.

2. Only challenges to the legality of a particular provision are reviewed narrowly on public policy grounds.

This Court's *Moncharsh* decision recognized a rule of limited judicial review of an arbitrator's decision as to the legality of a "single provision of the overall employment contract." (*Moncharsh, supra*, 3 Cal.4th at p. 32.) Such provision-illegality challenges must be decided by the arbitrator and thus, can trigger concerns

about arbitral finality. (*Id.* at pp. 30-33.) *Moncharsh* authorizes a narrow public-policy review of such single-provision arbitral decisions: "We recognize that there may be some limited and exceptional circumstances justifying judicial review of an arbitrator's decision *when a party claims illegality affects only a portion of the underlying contract.*" (*Id* at p. 32, italics added.)

But *Moncharsh* made clear that the concerns that require limited review of an arbitral determination of a particular provision's illegality do not apply to challenges to the entire contract, which are not arbitrable: "[T]he normal rule of limited judicial review [of an arbitrator's decision] may not be avoided by a claim that *a provision* of the contract, construed or applied by the arbitrator, is 'illegal,' except in rare cases when according finality to the arbitrator's decision would be incompatible with the protection of a statutory right." (*Id.* at p. 33, italics added.) But such "'rules which give finality to the arbitrator's determination of ordinary questions of fact or of law are inapplicable *where the issue of illegality of the entire transaction*'" is raised. (*Id.* at p. 31, quoting and adding italics to *Loving, supra,* 33 Cal.2d at p. 609.)

This Court recently reaffirmed the *Moncharsh* distinction in *Richey v. AutoNation, Inc.* (2015) 60 Cal.4th 909. It recognized "that [full] judicial review may be warranted when a party claims that an arbitrator has enforced an entire contract or transaction that is illegal." (*Id.* at p. 917.) It then stated that more limited judicial review is appropriate only "'when a party claims illegality affects only a portion of the underlying contract.'" (*Ibid.*)

The Courts of Appeal have consistently done the same. (E.g., *Epic Medical Management, LLC v. Paquette* (2015) 244 Cal.App.4th 504, 513 [applying *Moncharsh*'s "'limited and exceptional circumstances'" review of arbitrator's

determination regarding partial illegality only *after* rejecting argument that the contract was entirely illegal].)

* * * * *

Precedent sets forth the well-worn distinction between challenges to the legality of the entire contract and challenges to a particular provision. There is no undecided issue warranting this Court's attention.

B. The Desire Of Some Large Law Firms To Obtain So-Called Advance Conflict Waivers Presents No Important, Unresolved Issue.

The Petition essentially argues that some large law firms are too big to be hamstrung by long-established ethical rules that govern other lawyers, such as the rule requiring clients' informed consent to potential conflicts. But this case concerns an *actual* conflict, not a potential one. The rules governing this situation are clear; they pose no important, unresolved question of California law. And to the extent that the Petition seeks to remake California's ethical rules, the Petition is the wrong vehicle.

1. This case is about an actual conflict of interest, not a potential one that might be addressed by an advance conflict waiver.

This case does not present any real issue concerning advance conflict waivers. As the Petition's authorities hold, an advance conflict waiver is "one that is granted *before* the conflict arises and generally *before* its precise parameters (e.g., specific adverse client, specific matter) are known." (D.C. Bar Assn., Ethics Opn. 309 (2001) (D.C. Ethics Opn. 309), italics added; see also ABA Model Rules of Prof. Conduct, rule 1.7, com. 22 [advance waiver concerns "conflicts that might arise in the future"].) But here, the clients—J-M and South Tahoe—were known

adversaries in the J-M qui tam action. The law firm failed to disclose an existing, actual conflict.

It is undisputed that South Tahoe was the firm's client long before J-M engaged the firm to defend it. (Opn., pp. 4, 17.) That representation, as defined by the engagement agreement between Sheppard Mullin and South Tahoe, was not limited to a particular case or time period. Rather, South Tahoe retained the firm to provide periodic advice on labor and employment issues on an as-needed basis, year in and year out. (2 AA 288.) The firm provided such advice just five months before and within three weeks after undertaking the J-M representation. (Opn., pp. 4, 6, 17.)

There is no hint that the firm or South Tahoe terminated their on-going relationship before J-M signed its engagement agreement, or that South Tahoe entered into a new engagement agreement in the weeks following the J-M agreement. The firm's own, post-dispute correspondence confirmed the "'long-standing relationship between [South Tahoe] and our Firm,'" during which the firm had been "'pleased to provide labor advice to you for the last 9 years.'" (Opn., p. 7.)

And it is undisputed that the firm's conflict check identified the conflict with South Tahoe. (Opn., p. 17.) The conflict-waiver provision acknowledged that the firm "may *currently* or in the future represent" other clients, "including *current*, former, and future clients . . . in matters involving [J-M]." (Opn., p. 5.) The firm never discussed with J-M or explained to it what these conflicts might be. (*Ibid.*) In fact, the firm lied, telling J-M that there were no conflicts. (*Ibid.*)

Even under the Petition's proffered view, where advance waivers are allowed, the lawyer still "must make full disclosure of facts of which she is aware, and hence cannot seek a general waiver where she knows of a specific *impending*

adversity unless that specific instance also is disclosed." (D.C. Ethics Opn. 309, italics added.) Here, there is no doubt that the South Tahoe representation was at least impending. The firm had contracted to provide South Tahoe with periodic labor-and-employment advice. (2 AA 288.) J-M's lawyers at the firm did not even bother to check with the partner handling South Tahoe, which presumably would have revealed that the conflict was impending—it would spring into existence the moment South Tahoe returned for its next installment of periodic advice, as it had done for the better part of a decade and as it did just three weeks after the J-M engagement agreement. (See pp. 9-10, *ante*.) Even if the firm were not actively representing South Tahoe at the moment J-M signed the engagement agreement, an advance waiver would not permit the firm to hide an impending, actually-contemplated adversity.

2. Initiating changes to the rules for advance conflict waivers is appropriately left to other forums.

The current ethical status of advance conflict waivers presents no unresolved issue in California. The existing rules are clear.

But if there is to be a challenge, the appropriate forum is the ethics rule-making process. As recently as 2010, the State Bar considered a proposal to change Rule 3-310 to permit advance conflict waivers to function more like the way the Petition urges. (Proposed Rule 1.7, com. 22 <http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=7MbhFr6ih-w%3D&tabid=2161> [as of Mar. 28, 2016] (Proposed Rule. 1.7, com. 22) [draft dated Feb. 28, 2010].) That proposal was never adopted. A petition for review is the wrong vehicle to attempt to revive that unsuccessful rule-making effort to weaken California ethical standards.

Here is the backstory: In early 2002, the ABA revised the Model Rules of Professional Conduct to specifically permit broad, open-ended advance conflict

waivers by sophisticated parties represented by independent counsel. (ABA Model Rules of Prof. Conduct, rule 1.7, com. 22; see ABA Com. on Prof. Ethics, Opn. No. 05-436 (2005) p. 2.) In 2005, the ABA issued Formal Opinion 05-436 elaborating on that model rule and its comments. The D.C. Bar Association and the Restatement tackled the issue in the same time frame. (See Petition, p. 22.)

In 2008, with all of this information in hand and "[f]ollowing intensive lobbying efforts by large law firms," the California Rules Revision Commission proposed a draft revision to California's Rules of Professional Conduct that was modeled on ABA Model Rule 1.7. (Buckner, *Addressing the Intricacies of Future Conflict Waivers* (2008) 50-NOV Orange County Law. 46, 47; see Proposed Rule 1.7, com. 22.) Proposed California Rule 1.7 tracked much of the sea-change that the Petition now advocates, i.e., open-ended advance conflict waivers if the client is an "experienced user" of legal services and is represented by independent counsel. (*Ibid.*) The proposal was considered as recently as 2010. (See Proposed Rule 1.7 [dated Feb. 28, 2010].)

Proposed Rule 1.7 was never adopted. Thus, California considered, but never changed, the rules that protect clients by ensuring their attorneys' loyalty. End-running that process via a petition for review is improper.

For one thing, it is not this Court's proper role to change professional responsibility rules in the guise of reviewing a Court of Appeal decision that applies existing law. The rule-making process affords *all* stakeholders with *notice* and the opportunity to *comment* in a way that the briefing process does not. End-running that process is particularly inappropriate when, as here, the suggested change was considered, but failed to be adopted just a few years ago. Significantly, the proposal failed despite the so-called "trend" toward adopting the view of the ABA Model's Rules.

In addition to being more open and accessible, the rule-making process is fairer and more credible where the issue at stake is whether to change ethical rules in a way that helps attorneys to the detriment of their clients.

C. The Court Of Appeal Applied Existing Law Holding That Disgorgement Is Required For Some But Not All Conflicts Of Interest.

The Petition asserts that the Court of Appeal "created a per se rule that any conflict of interest—no matter how minor or unrelated; no matter when or how it arose; irrespective of the attorney's good faith; and regardless of whether confidential information was used or the conflict damaged the client—automatically requires an attorney to disgorge all earned legal fees." (Petition, p. 23; see also Petition, pp. 26-30.) The Court did no such thing. It expressly stated that it "follow[ed] established California law" to determine that *in these particular circumstances* the law firm was not entitled to fees. (Opn., p. 3.)

On its face, the Opinion states that not every conflict of interest is sufficient to warrant disgorgement and denial of fees. It distinguishes between "serious" conflicts of interest and "technical violations or potential conflicts." (Opn., pp. 26-29 & fn. 10.) It devotes numerous pages to explaining that the firm's violation was so serious that it cut to "the very foundation of [the] attorney-client relationship." (Opn., pp. 18, 22-27.) The Petition itself candidly acknowledges that the Court of Appeal held that disgorgement and forfeiture were required because the firm had committed a "'serious ethical breach.'" (Petition, p. 24.) So, contrary to the Petition's assertion, the Court of Appeal did not create a per se rule requiring fee forfeitures for minor ethical breaches. Rather, the Court made a factual determination that the ethical breach here was very serious, requiring disgorgement.