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IN THE SUPREME COURT OF CALIFORNIA

SHEPPARD, MULLIN, RICHTER & HAMPTON LLP,

Plaintiff and Respondent,

v.

J-M MANUFACTURING CO., INC.,

Defendant and Appellant.

After a Decision of the Court of Appeal of the State of California,
Second Appellate District, Division Four, Case No. B256314

The Superior Court of Los Angeles County, Case No. YC067332
The Honorable Stuart M. Rice, Presiding

OPENING BRIEF ON THE MERITS

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TABLE OF CONTENTS

Page

ISSUES PRESENTED FOR REVIEW 1

INTRODUCTION 1

STATEMENT OF THE CASE 5

I. Sheppard Mullin's Representation of J-M 5

II. The Engagement Agreement Between J-M and Sheppard Mullin 5

III. Sheppard Mullin's Representation of South Tahoe 7

IV. South Tahoe's Disqualification Motion 8

V. The Arbitration Panel Rules in Sheppard Mullin's Favor, and the Trial Court Confirms the Panel's Award 10

VI. The Court of Appeal's Decision 12

ARGUMENT 12

I. Courts Cannot Vacate Arbitration Awards Based on Non-Legislative Expressions of Public Policy 12

A. Vacating an Arbitration Award on Illegality Grounds Requires a Legislative Expression of Public Policy 13

B. The Rules of Professional Conduct Cannot Be Used to Vacate an Arbitration Award on Illegality Grounds 18

C. The Court of Appeal's Expansive View of the Illegality Exception Cannot Be Salvaged Based on the Contention That the Engagement Agreement Was "Entirely" Illegal 23

II. For Sophisticated Clients Represented by Independent Counsel, "Informed Written Consent" Means Understanding the Scope of the Waiver and the Nature of the Conflicts It Covers 26

A. Under Rule 3-310(C)(3), a Sophisticated Client Represented by Independent Counsel Can Give Informed Consent to a Comprehensive Waiver of Conflicts 27

B. J-M Gave Informed Written Consent to the Waiver of the Conflict Regarding South Tahoe 31

TABLE OF CONTENTS
(continued)

Page

C. The Modern Legal Marketplace Calls for an Informed Consent Standard Tailored to Sophisticated Clients Represented by Independent Counsel 37

III. Even If the Conflict Waiver Is Deemed Invalid, Sheppard Mullin Was Entitled to Retain and Recover Its Attorneys' Fees Under the Circumstances Here 40

A. J-M Cannot Obtain Disgorgement of Past Fees Because It Stipulated That It Suffered No Damages 41

B. A Conflict of Interest Does Not Automatically Require Forfeiture of All Legal Fees 44

CONCLUSION 50

TABLE OF AUTHORITIES

Page(s)

Cases

Aguilar v. Lerner
(2004) 32 Cal.4th 974 .... 16, 20

Ahdout v. Hekmatjah
(2013) 213 Cal.App.4th 21 .... 13, 19, 25, 26

All Points Traders, Inc. v. Barrington Associates
(1989) 211 Cal.App.3d 723 .... 15, 23

Anderson v. Eaton
(1930) 211 Cal. 113 28

In re Attorney Discipline Sys.
(1998) 19 Cal.4th 582 22

Board of Education v. Round Valley Teachers Assn.
(1996) 13 Cal.4th 269 16

Burrow v. Arce
(Tex. 1999) 997 S.W.2d 229 47

Cable Connection, Inc. v. DirecTV, Inc.
(2008) 44 Cal.4th 1334 18

Cel-Tech Communications, Inc. v. L.A. Cellular Telephone Co.
(1999) 20 Cal.4th 163 18

Christensen v. Dewor Developments
(1983) 33 Cal.3d 778 17

City & Cnty. of San Francisco v. Cobra Solutions, Inc.
(2006) 38 Cal.4th 839 28

Clark v. Millsap
(1926) 197 Cal. 765 .... 45, 46, 47, 48

Cotchett, Pitre & McCarthy v. Universal Paragon Corp.
(2010) 187 Cal.App.4th 1405 .... 19, 24

Epic Medical Management, LLC v. Paquette
(2015) 244 Cal.App.4th 504 26

TABLE OF AUTHORITIES
(continued)

Page(s)

Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street
(1983) 35 Cal.3d 312 .... 14, 17, 20

Frye v. Tenderloin Housing Clinic, Inc.
(2006) 38 Cal.4th 23 42

Galderma Laboratories, L.P. v. Actavis Mid Atlantic LLC
(N.D.Tex. 2013) 927 F.Supp.2d 390 .... 31, 36

General Dynamics Corp. v. Superior Court
(1994) 7 Cal.4th 1164 21

Gilchrist v. Perl
(Minn. 1986) 387 N.W.2d 412 48

Goldstein v. Lees
(1975) 46 Cal.App.3d 614 .... 45, 46, 48

Green v. Ralee Engineering Co.
(1998) 19 Cal.4th 66 .... 22, 23

Huskinson & Brown, LLP v. Wolf
(2004) 32 Cal.4th 453 .... 45, 46

Internat. Materials Corp. v. Sun Corp.
(Mo. 1992) 824 S.W.2d 890 47

Jeffry v. Pounds
(1977) 67 Cal.App.3d 6 .... 45, 46, 48

Johnson v. Ford Motor Co.
(2005) 35 Cal.4th 1191 49

Lindenstadt v. Staff Builders, Inc.
(1997) 55 Cal.App.4th 882 15

Loving & Evans v. Blick
(1949) 33 Cal.2d 603 .... 14, 15, 23, 24, 26

Macy's, Inc. v. J.C. Penn[e]y Corp.
(App. Div. 2013) 968 N.Y.S.2d 64 31

Mardirossian & Associates, Inc. v. Ersoff
(2007) 153 Cal.App.4th 257 .... 46, 48

TABLE OF AUTHORITIES
(continued)

Page(s)

In re Marriage of Pagano
(Ill. 1992) 607 N.E.2d 1242 48

Maxwell v. Superior Court
(1982) 30 Cal.3d 606 28

Moncharsh v. Heily & Blase
(1992) 3 Cal.4th 1 .... 13, 14, 15, 16, 17, 18, 19, 21, 23, 24, 25

Oasis W. Realty, LLC v. Goldman
(2011) 51 Cal.4th 811 41

Olson v. Cohen
(2003) 106 Cal.App.4th 1209 42

Pringle v. La Chapelle
(1999) 73 Cal.App.4th 1000 .... 46, 47, 48

Richey v. AutoNation, Inc.
(2015) 60 Cal.4th 909 .... 13, 16

Singerlewak LLP v. Gantman
(2015) 241 Cal.App.4th 610 16

Slovensky v. Friedman
(2006) 142 Cal.App.4th 1518 .... 42, 43

Sullivan v. Dorsa
(2005) 128 Cal.App.4th 947 .... 47, 48

Visa U.S.A. Inc. v. First Data Corp.
(N.D. Cal. 2003) 241 F.Supp.2d 1100 .... 34, 35

Zador Corp. v. Kwan
(1995) 31 Cal.App.4th 1285 34

Statutes

Bus. & Prof. Code, § 650 26

Bus. & Prof. Code, § 6068 42

Bus. & Prof. Code, § 6076 22

Bus. & Prof. Code, § 6077 22

TABLE OF AUTHORITIES
(continued)

Page(s)

Code Civ. Proc., § 1280 et seq. 3, 13, 21, 22, 24

Code Civ. Proc., § 1286.2, subd. (a) 14

Code Civ. Proc., § 1286.2, subd. (a)(4) 14

Corp. Code, § 13406, subd. (b) 42

Lab. Code, § 1102.5, subd. (b) 23

Rules

ABA Model Rules of Prof. Conduct, rule 1.7 .... 29, 34, 36

Rules Prof. Conduct, rule 1-100(A) 18, 19, 28

Rules Prof. Conduct, rule 2-200 45

Rules Prof. Conduct, rule 3-110(C) 20

Rules Prof. Conduct, rule 3-310 .... 14, 19, 30, 35, 42, 43, 46, 47

Rules Prof. Conduct, rule 3-310(A)(1) 28

Rules Prof. Conduct, rule 3-310(A)(2) 28

Rules Prof. Conduct, rule 3-310(B)(1) 20

Rules Prof. Conduct, rule 3-310(C)(3) 12, 20, 26, 27, 29, 31, 40, 48

Rules Prof. Conduct, rule 3-400(A) 20

Rules Prof. Conduct, rule 4-200(A) 19, 20

Other Authorities

ABA Com. on Prof. Ethics, Opn. No. 05-436 (2005) 29, 30, 34

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D.C. Bar Assn., Ethics Opn. 309 (2001) 30, 37

Kobak, *Dealing with Conflicts and Disqualification Risks Professionally* (2015) 44 Hofstra L.Rev. 497 39

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(continued)

Page(s)

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Rest.3d Law Governing Lawyers (2000) § 37 47

Rest.3d Law Governing Lawyers (2000) § 122 .... 31, 34, 36

State Bar Standing Com. on Prof. Responsibility & Conduct, Formal Opn. No. 1989-115 30

Wendel, *Pushing the Boundaries of Informed Consent: Ethics in the Representation of Legally Sophisticated Clients* (2015) 47 U.Tol. L.Rev. 39 .... 38, 39

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ISSUES PRESENTED FOR REVIEW

1. May a court rely on non-legislative expressions of public policy to overturn an arbitration award on "illegality" grounds?

2. Can a sophisticated consumer of legal services, represented by independent counsel, give its informed consent to an advance waiver of conflicts of interest?

3. Does a conflict of interest that undisputedly caused no damage to the client and did not affect the value or quality of an attorney's work automatically (i) require the attorney to disgorge all previously paid fees, and (ii) preclude the attorney from recovering the reasonable value of his unpaid work?

INTRODUCTION

This case is about whether a sophisticated and powerful corporate client, represented by independent counsel, can engage the outside law firm of its choice, heavily negotiate an engagement agreement, provide informed consent to a conflict waiver, agree to arbitrate any claims, and then—after the firm provides millions of dollars in valuable legal services, the client admittedly suffers no damages, and the matter is fully and fairly vetted before a distinguished panel of arbitrators—renege on the conflict waiver, nullify the arbitration agreement, refuse to pay any legal fees, and obtain a $4 million windfall. Because precedent and public policy preclude such a result, the Court should reverse the Court of Appeal's decision to the contrary.

When J-M Manufacturing Co., Inc.—the world's largest PVC pipe manufacturer—faced potentially ruinous liability in a $1 billion federal qui tam action, it turned to Sheppard Mullin. J-M valued Sheppard Mullin's

expertise and relationships with some of the governmental entities with potential claims against J-M in the qui tam action. After extensive negotiation, review, and editing by J-M's General Counsel, Sheppard Mullin and J-M signed a written engagement agreement governing not only the qui tam action, but also any future matters. That agreement included an arbitration provision. As part of the engagement agreement, J-M waived any conflicts of interest arising from Sheppard Mullin's representation of current, former, and future clients in unrelated matters, so long as Sheppard Mullin had not obtained any of J-M's confidential information relevant to those matters.

Over the next 16 months, Sheppard Mullin performed 10,000 hours of legal work for J-M in the qui tam action. But then another Sheppard Mullin client (the South Tahoe Public Utility District)—which held 0.0004% of the potential qui tam claims against J-M and itself previously had provided two advance conflict waivers to Sheppard Mullin—successfully moved to disqualify the firm based on Sheppard Mullin's provision of 12 hours of entirely unrelated labor consultation beginning shortly after J-M engaged Sheppard Mullin. J-M initially encouraged Sheppard Mullin to fight disqualification, and the federal district court proposed a solution to avoid disqualification. But J-M rejected that proposal shortly after being advised by two other law firms that it could seek disgorgement of the $2.7 million in fees it already had paid and avoid paying the $1.1 million in outstanding fees it owed if Sheppard Mullin was disqualified.

Even though J-M stipulated both that it suffered no damages from either the conflict or the disqualification and that it was not challenging the quality of Sheppard Mullin's work, it nonetheless asserted in this action that the conflict with South Tahoe meant that Sheppard Mullin was not

permitted to retain or recover any fees for its work in the qui tam action. The parties arbitrated this dispute, and the arbitration panel ruled in Sheppard Mullin's favor after finding that Sheppard Mullin had acted in complete good faith in its dealings with J-M.

J-M seeks to escape this arbitration award. J-M contends that the conflict with South Tahoe rendered the engagement agreement "illegal" because J-M supposedly did not give informed consent to the conflict waiver it signed, even though it is a sophisticated business and was represented by independent counsel who negotiated that agreement. J-M also asserts that *any* actual conflict of interest requires attorneys to forfeit *all* fees they earned after the conflict arose—even where they acted in good faith, no confidential information was disclosed, and the client suffered no injury. The Court of Appeal agreed with J-M on each of these issues, vacated the arbitration award, and held that Sheppard Mullin was not entitled to any compensation for its legal work for J-M. This Court should reverse.

First, the Court should deny J-M's attempt to obtain judicial review of the arbitration award because it is premised on an alleged violation of the Rules of Professional Conduct—a non-legislative expression of public policy. In enacting the California Arbitration Act, the Legislature strictly limited judicial review of final arbitration awards. Therefore, as this Court has emphasized, only *legislative* expressions of public policy may serve as a basis to vacate an arbitration award under the Act's narrow exceptions. Any contrary rule would have profound practical consequences and would lead to frequent challenges to the finality of arbitration awards, especially in attorney-client disputes given the broad scope of the Rules of Professional Conduct. The Court should reject this significant expansion of judicial review of arbitration awards, hold that the trial court properly

confirmed the award in favor of Sheppard Mullin, and decline to reach any other issue.

Second, J-M—a powerful and savvy client advised by independent counsel—gave informed written consent to waive the conflict at issue. Sheppard Mullin disclosed in writing that it had many lawyers and multiple offices and that it may currently or in the future represent clients with interests adverse to J-M in unrelated matters where J-M's confidential information was irrelevant. Yet J-M now contends that its informed consent required specification in the first instance of each client falling within the scope of the waiver—even though the plain language of the waiver made clear to J-M exactly what it covered, and J-M never expressed interest in specification of client names. The Court should reject this opportunistic argument and recognize, like the American Bar Association, the Restatement, prominent scholars, and many courts, that sophisticated clients represented by independent counsel need far less specific disclosures to make their consent to waive conflicts sufficiently informed.

Third, the Court should reject J-M's contention that any conflict of interest automatically requires complete fee forfeiture. J-M should not be awarded a $4 million windfall based on such a per se rule that fails to account for either J-M's lack of injury or Sheppard Mullin's good faith effort to comply with the Rules. Such an arbitrary, inflexible, and punitive standard, wholly disproportionate to both the client's injuries and the firm's culpability, is unfair and should not be adopted. Rather, the propriety and extent of any fee forfeiture should account for the egregiousness of the conduct, the harm to the client, and the attorney's good faith.

STATEMENT OF THE CASE

I. Sheppard Mullin's Representation of J-M

Sheppard Mullin represented J-M in a federal qui tam action alleging that J-M misrepresented the strength of its plastic pipe and sold defective pipe to nearly 200 governmental entities. (Opn. at p. 3; 1AA53B; 2AA490-491.) J-M reached out to Sheppard Mullin after firing its previous law firm, which it later sued for alleged malpractice. (2AA473-474; 2AA494-495.)

J-M chose Sheppard Mullin in part because it valued the expertise of the two former Assistant U.S. Attorneys who would lead the Sheppard Mullin team. (2AA471, 474-475; 2AA488, 490-492.) J-M's General Counsel said that the firm's relationships with some of J-M's potential adversaries in the qui tam action, including its former client the Los Angeles Department of Water and Power, would be useful in attempting to resolve the qui tam action. (2AA474-475; 2AA490-492.) One of the Sheppard Mullin attorneys even told J-M's General Counsel that he "hoped to represent the LADWP again in the future," and she did not "express[] any concern whatsoever" about that prospect. (Motion for Judicial Notice and Supporting Declaration ("MJN Decl."), Ex. E at p. 2.)

II. The Engagement Agreement Between J-M and Sheppard Mullin

Before agreeing to represent J-M in the qui tam action, Sheppard Mullin provided a draft engagement agreement to J-M. (Opn. at p. 5; 1AA191.) The lead Sheppard Mullin partner discussed the agreement—which included an arbitration clause and a conflict waiver—at a two-hour meeting with J-M's General Counsel. (Opn. at p. 5.) During this meeting about the draft agreement, J-M's General Counsel negotiated a 15% discount off Sheppard Mullin's fees and an additional 7% prompt-pay

discount for payments within 30 days. (2AA477.) J-M's General Counsel then took several days to consider and edit the agreement with J-M's CEO. (Opn. at pp. 5-6; 2AA475-478.)

The agreement informed J-M that Sheppard Mullin "may *currently or in the future* represent one or more other clients (including *current*, former, and future clients) in matters involving [J-M]." (1AA201, italics added.) The conflict waiver limited the permitted adversity to *unrelated* matters and to instances in which Sheppard Mullin had "not obtained confidential information" from J-M that would be "material to representation of the other client." (1AA201.) With those limitations, J-M agreed that Sheppard Mullin could represent other clients, "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*)." (1AA201, italics added.) J-M represented that it had "read and underst[ood] this engagement letter and agree[d] that it ... waived any conflict of interest on the part of [Sheppard Mullin] arising out of the representation described above." (1AA204.)

J-M's General Counsel "made a number of handwritten edits related to the fee provisions" in the engagement agreement, and "also edited the paragraph preceding the conflict waiver provision," but "she did not edit the conflict waiver provision." (Opn. at pp. 5-6.) In so doing, J-M was acutely aware of the significance of conflict waivers. According to J-M's General Counsel, J-M "had never waived any conflict for any of its other (past or present) attorneys," and on the same day it agreed to the conflict waiver with Sheppard Mullin, J-M "refused to grant a conflict waiver to Morgan Lewis." (1AA192.)

Sheppard Mullin performed over 10,000 hours of work for J-M in the qui tam action. (Opn. at p. 4; 2AA493.) J-M stipulated below that it "waive[d] any argument challenging[] the value or quality of Sheppard Mullin's work," including "any challenge to the nature or amount of Sheppard Mullin's bills or the substantive work performed by any of its lawyers or other personnel." (3AA580.) J-M also "waive[d] any claims for ... any costs or expenses associated with the replacement of Sheppard Mullin" as counsel in the qui tam action. (3AA581; see also Opn. at p. 9.)

III. Sheppard Mullin's Representation of South Tahoe

Before agreeing to represent J-M, Sheppard Mullin conducted a conflict check regarding each of the approximately 200 governmental entities identified in the qui tam complaint. (2AA475.) One of those entities was South Tahoe, which held 0.0004% of the potential claims at issue ($97,000 of more than $1 billion). (2AA480; 2AA498-499; 1AA53B-53C.) The conflict check revealed that a lawyer in a different Sheppard Mullin office had finished a labor arbitration for South Tahoe five months earlier, but Sheppard Mullin had done no work for South Tahoe since. (2AA512-514; 2AA538-540.) Sheppard Mullin's work for South Tahoe was unrelated to J-M or the qui tam action and was not adverse to J-M.

The conflict check further revealed that South Tahoe had consented twice to conflict waivers with Sheppard Mullin that allowed Sheppard Mullin to represent parties adverse to South Tahoe in unrelated matters. (2AA516-526.) Accordingly, Sheppard Mullin saw no need to inform South Tahoe of the potential representation of J-M in the unrelated qui tam matter, or J-M of Sheppard Mullin's work for South Tahoe. (2AA475-476; 2AA538-540; see also MJN Decl., Ex. H at pp. 4-6 [supp. expert report of Prof. Marshall].)

On March 29, 2010—three weeks after J-M signed the engagement agreement—Sheppard Mullin "began actively working for South Tahoe again" on a matter wholly unrelated to J-M. (Opn. at p. 6.) During the ensuing 16 months that it represented J-M, Sheppard Mullin billed approximately 12 hours of unrelated labor advice to South Tahoe. (2AA512-514.) No confidential information concerning J-M was ever disclosed to South Tahoe, and nothing about the qui tam action had any relevance to Sheppard Mullin's work for South Tahoe. (3AA677-678; 2AA513-514.)

IV. South Tahoe's Disqualification Motion

About a year later, in March 2011, in a letter to Sheppard Mullin, one of the lawyers who represented many of the governmental entities in the qui tam action, including South Tahoe, noted that Sheppard Mullin had "represented South Tahoe in other matters," and asked how it was "permissible" for Sheppard Mullin to be "adverse to South Tahoe." (2AA303-304.) The Sheppard Mullin lawyers believed this lawyer was unaware South Tahoe had agreed to a conflict waiver squarely covering the situation. (MJN Decl., Ex. E at p. 4; MJN Decl., Ex. G at pp. 2-3.) They therefore responded that South Tahoe had agreed to a conflict waiver. (2AA306.) The same lawyer then requested additional information about the conflict waiver. (2AA308-309.) Sheppard Mullin reiterated that South Tahoe had waived the conflict and noted that South Tahoe had been aware of Sheppard Mullin's representation of J-M for almost a year. (2AA311.)

Nearly three weeks later, on April 11, 2011, a different lawyer representing South Tahoe in the qui tam action sent an email stating for the first time that South Tahoe was "contemplating" a disqualification motion, and seeking to schedule a meeting to discuss the matter. (2AA342.) The

Sheppard Mullin lawyers believed this lawyer "either didn't know about or didn't understand South Tahoe's advance waiver." (MJN Decl., Ex. G at p. 4; see also MJN Decl., Ex. E at pp. 4-5.) But when they discussed the matter with South Tahoe's qui tam counsel, it "became clear" for the first time that they "simply did not intend to honor South Tahoe's conflict waiver." (MJN Decl., Ex. E at p. 5; see also MJN Decl., Ex. G at pp. 4-5.) The next day, Sheppard Mullin informed J-M's General Counsel about the threatened disqualification motion. (1AA214; MJN Decl., Ex. G at p. 5.)

On May 9, 2011, roughly 14 months after Sheppard Mullin began representing J-M, South Tahoe moved to disqualify Sheppard Mullin in the qui tam action. (2AA319-339.) The federal court issued a tentative ruling finding a conflict from the perspective of South Tahoe, but asked for supplemental briefing regarding possible solutions that might avoid disqualification. (2AA351-352.) J-M then encouraged Sheppard Mullin to continue working aggressively on the case and to fight disqualification. (2AA482-483; 2AA501-506.) Indeed, J-M's CEO called Sheppard Mullin and J-M "a 'team' and a 'family'" and stated that "he viewed the disqualification motion as a distraction and disruption." (2AA482; 2AA502.) J-M also authorized Sheppard Mullin to offer compensation, in the "form of cash" and "some free labor law advice," to South Tahoe to resolve the disqualification issue. (MJN Decl., Ex. D; 2AA483-484, 2AA502-504.) South Tahoe rejected Sheppard Mullin's $250,000 offer, even though it was more than double its $97,000 damages claim. (2AA483-484; 2AA504-505.)

The federal court subsequently proposed that, under certain modest conditions, including bifurcation of South Tahoe's claim and the appointment of separate counsel for J-M with respect to that claim (at Sheppard Mullin's expense), it would permit Sheppard Mullin to continue

representing J-M as to the remainder of the claims (99.9996%) in the qui tam action. (2AA400; 2AA484-485; 2AA506-507; 1AA234-237.) The district court gave J-M one week to consider this proposal. (1AA234; 1AA196.) During that week, J-M's General Counsel was advised by other outside counsel that J-M could seek disgorgement of its previously paid fees and avoid paying its outstanding invoices if Sheppard Mullin were disqualified. (1AA196-197; 1AA242-267.) J-M then rejected the federal court's proposal; the court consequently disqualified Sheppard Mullin. (1AA196-197; 1AA269; 2AA405.)

V. The Arbitration Panel Rules in Sheppard Mullin's Favor, and the Trial Court Confirms the Panel's Award

After the disqualification, J-M refused to pay its outstanding legal fees and "demanded that Sheppard Mullin pay back to J-M all fees J-M had paid to Sheppard Mullin pertaining to the Qui Tam Action and related litigation." (2AA486.) In response, Sheppard Mullin filed suit and moved to compel arbitration. (1AA1-7; 1AA41-53.) J-M opposed, arguing that the engagement agreement was unconscionable and fraudulently induced because Sheppard Mullin had not disclosed its relationship with South Tahoe. (1RA20-37.) After Sheppard Mullin demonstrated that fraud in the inducement and unconscionability are not grounds to avoid arbitration (1RA42-44), J-M repackaged the same arguments and evidence into a claim that the agreement was "illegal." (1AA54-58.) The trial court rejected J-M's arguments and compelled arbitration. (Opn. at pp. 8-9; 1AA59-65.)

Before the arbitration panel—which included a retired California Court of Appeal justice and a retired federal judge—Sheppard Mullin sought recovery of its unpaid fees, while J-M asserted tort cross-claims seeking disgorgement of all paid fees as a remedy. (3AA670-672.) The panel ruled in Sheppard Mullin's favor. (3AA670-679.)

The arbitration panel found that Sheppard Mullin at all times had acted "honestly and in good faith believed that no conflict existed when it undertook the Qui Tam defense." (3AA674; see also MJN Decl., Ex. C at pp. 32, 34-35, 37, 46-48 [expert report of Professor Lawrence C. Marshall].) It further found that any ethical violation "was not so serious or egregious as to make appropriate a disgorgement or forfeiture of fees." (3AA677.) The unrefuted evidence demonstrated that Sheppard Mullin's work for South Tahoe had ended five months earlier, and South Tahoe twice had consented to a conflict waiver. (2AA476; 2AA521, 547-548; MJN Decl., Ex. E at pp. 1-2.) Sheppard Mullin also disclosed to J-M in the engagement agreement that it "may currently" represent clients that "are adverse" to J-M in unrelated matters. (1AA201.) In response to Sheppard Mullin's evidence of good faith, J-M's General Counsel told the panel that Sheppard Mullin "assured" her orally "that there were no conflicts" before signing the engagement agreement (1AA191)—an assertion that Sheppard Mullin denied. (2AA477; 2AA493; MJN Decl., Ex. E at p. 2; MJN Decl., Ex. I at pp. 1-2.)

The panel assumed (without deciding) that there was a conflict of interest, but concluded there is no "automatic" fee forfeiture rule; instead, an "equitable weighing test" applies. (3AA674-676.) The panel then found that neither the conflict nor the resulting disqualification: (1) caused J-M any damage; (2) resulted in disclosure of J-M's confidences; (3) rendered Sheppard Mullin's representation less effective; (4) adversely affected the value of its services; (5) prejudiced J-M's defense in the qui tam action; or (6) "pervade[d] [Sheppard Mullin's] whole relationship" with J-M. (3AA677-678.) The panel awarded Sheppard Mullin its unpaid fees and denied J-M's disgorgement request. (3AA679.)