Supreme Court Case No. S232946

IN THE SUPREME COURT

OF THE STATE OF CALIFORNIA

SHEPPARD, MULLIN, RICHTER & HAMPTON, LLP *Plaintiff and Respondent,* vs. 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

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INTRODUCTION

As much as petitioner Sheppard, Mullin, Richter & Hampton LLP (Sheppard) would like this case to be about a crafty client cheating its lawyer out of fees by reneging on a conflict waiver that was completely above-board (Opening Brief on the Merits (OBM), p. 1), that narrative doesn't survive even the most casual review of the *undisputed* facts and the *unbroken* lines of legal authority that govern here. Those facts and law show that Sheppard induced its client J-M Manufacturing Co. (J-M) to sign a broad, open-ended waiver of all future *and current* conflicts—a waiver invalid under the law of any jurisdiction—by concealing the present or impending conflict that Sheppard knew about and instead assuring J-M there were "no conflicts." Following the rules applied in every California appellate decision that has ever considered the issues, the Court of Appeal held the engagement agreement that was forged by this deception was entirely illegal and unenforceable as against public policy, because it violated the most fundamental duty a lawyer owes to a client—the duty of loyalty, which goes to the very heart of the attorney-client relationship.

Sheppard's three disparate arguments seeking to undo the Court of Appeal's all-but-inevitable conclusion share one thing in common: As to all three, even the authorities that Sheppard relies upon are directly against it.

First, Sheppard argues that *Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1 (*Moncharsh*) held that a contract with an arbitration clause is illegal and unenforceable only if it violates a statute or an "explicit *legislative* expression" of public policy. (OBM, pp. 12-13.) But *Moncharsh* and Sheppard's other authorities actually hold that this rule only applies where there is a claim that the contract is *partially* illegal—an issue that must be decided in the first instance by the arbitrator, whose decision is subject to only the most limited review. Where the issue is, as here, whether the entire contract that contains the arbitration clause is illegal, the

Legislature has expressly directed that that question must be decided by the trial court in the first instance, and that the arbitration clause is unenforceable if the entire contract is illegal for any reason that any other California contract would be illegal.

Second, Sheppard's conduct violated the ethical conflict rules even under the advance waiver rules of the jurisdictions on which Sheppard relies. No jurisdiction permits an attorney to conceal information about existing or impending conflicts by using a generalized, open-ended advance waiver. That is true regardless of the client's level of sophistication. Moreover, California's Rules of Professional Conduct are incompatible even with the relaxed advance waiver rules that have been adopted by other jurisdictions. And even the State Bar's currently-proposed rule change explicitly rejects that relaxed standard.

Third, Sheppard is wrong that California law requires a showing of compensatory damages before a law firm must forfeit its fees under a contract rendered illegal under the circumstances here. In the first place, Sheppard is wrong that J-M agreed it suffered no such damages—harm is undeniable. Moreover, Sheppard's own authority holds that compensatory damages are not—and should not be—a prerequisite to an attorney's forfeiture of fees for the violation of fundamental ethical duties like the conflicted representation here. California law is clear that an attorney is not entitled to compensation for services that are themselves prohibited by the rule against accepting actually-conflicting representations.

Sheppard's flagrant violation of the most basic attorney duty—the duty of loyalty to its client—cannot be immunized from judicial review by the inclusion of an arbitration clause in the engagement agreement. Nor do the ethical rules governing conflict waivers (advance or otherwise) of *any* jurisdiction permit a lawyer to obtain an open-ended waiver of current and future conflicts while concealing pertinent information about a present or impending conflict, as occurred

here. California law is clear and unequivocal: An attorney engagement agreement executed under these circumstances is illegal, and as a matter of public policy the attorney can receive no fees for the services tainted by the violation.

STATEMENT OF THE CASE

A. The Underlying Qui Tam Action.

In 2010, J-M approached Sheppard about handling its defense in a $1 billion qui tam action. (Opinion, pp. 3-4.) Sheppard partners Daly and Kreindler met with J-M. They mentioned that the firm had "relationships" that might be beneficial in the qui tam action. (2AA474-475.) In particular, they explained that their firm had experience working opposite the lawyer representing plaintiffs. (*Ibid.*) They also told J-M that one of the governmental intervenors—LADWP—was a *former* litigation client of the firm. (2AA475.)

B. Sheppard Is Aware Of The Conflict Of Interest Between J-M And South Tahoe.

Sheppard ran a conflicts check that "identified South Tahoe Public Utilities District [South Tahoe] as a client . . . ." (2AA317, ¶ 5; Opinion, p. 4.) South Tahoe was a plaintiff-side intervenor in the qui tam action and, thus, directly adverse to J-M. (2AA283, 294.)

South Tahoe had been Sheppard's client since 2002, with labor-and-employment partner Jeffrey Dinkin in charge of the representation. (Opinion, p. 4.) South Tahoe had been Dinkin's client since the beginning of his career, following him when he joined Sheppard. (2AA275-276, 278-279; Opinion, p. 4.) At his former firm, Dinkin would handle all of South Tahoe's employment-related issues. (2AA275.)

Sheppard twice memorialized its relationship with South Tahoe. (2AA276, 288-291.) Neither engagement agreement defined the attorney-client relationship as limited to "any particular matter" or time period. (2AA277.) Instead, they described the representation's scope as broadly covering "general employment matters," with Sheppard providing periodic advice on labor-and-employment issues

on an "as-needed" basis, year in and year out. (2AA278-279, 288; Opinion, p. 4.) South Tahoe had most recently obtained Sheppard's advice five months before the conflict check. (Opinion, p. 4.)

The open-ended engagement agreement provided that either party could terminate their relationship with notice. (2AA290.) No evidence showed either had done so.

C. Sheppard Does Not Disclose The Conflict To J-M, South Tahoe Or Even To Dinkin.

Concerned about the conflict, Daly and Kreindler consulted Sheppard's general counsel and assistant general counsel. (Opinion, p. 4.) They thought that South Tahoe could not stand in the way of the J-M representation because South Tahoe's had signed a broad advance conflict waiver. (2AA317, 476.)

But no agreement had yet been signed with J-M, and Sheppard did not inform J-M of the known conflict. To the contrary, it "assured [J-M's general counsel] that there were no conflicts with the firm's proposed representation in the Action." (1AA191.)

The firm then proffered an engagement agreement that contained the provision, "We *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 provision said J-M waived its "obligation of loyalty" by allowing Sheppard to represent this broad, undefined class of clients in matters adverse to J-M. (*Ibid.*)

Sheppard never discussed the waiver with J-M. (Opinion, p. 5.) Based on assurance that there were no conflicts, J-M signed the agreement. (1AA191, 204.) Both before and after this, J-M's practice has been to ensure outside counsel had no conflicts of interests. (1AA191-192.)

Sheppard did not just conceal the conflict from J-M; it concealed it from Dinkin, the Sheppard partner in charge of South Tahoe's account. (2AA280.)

D. South Tahoe Discovers The Conflict And Threatens Disqualification. Sheppard Still Remains Silent.

Three weeks after J-M signed the engagement agreement, Sheppard resumed active work on another South Tahoe employment issue—without any new engagement agreement—and continued to do so for a full year. (Opinion, p. 6; 2AA278-279.) Still, Sheppard did not inform either client—or Dinkin. (2AA280; Opinion, p. 18.)

In January 2011, South Tahoe discovered the conflict and demanded that Sheppard provide an "immediate explanation" regarding the "clear conflict of interest." (2AA284, 303-304.) On April 11, it notified Sheppard that it would disqualify Sheppard in the qui tam action. (1AA193.) Sheppard then acknowledged to South Tahoe that the conflicts check it had run before undertaking the J-M representation had "showed South Tahoe to be an existing client." (2AA284.)

Sheppard did not inform J-M about the issue until April 20—months after South Tahoe had raised it. (1AA193, 214.) Sheppard *never* directly told J-M about the conflicts check; J-M learned about that from a late-July court filing. (1AA192.)

Unbeknownst to J-M, Sheppard tried to buy its way out of the conflict, offering South Tahoe $100,000 plus free legal services if South Tahoe would waive the conflict; it later upped the offer to $250,000. (Opinion, pp. 7-8; 1AA194-195 [J-M never would have permitted such offer].)[1/]

[1/] In its correspondence, Sheppard confirmed the "'long-standing relationship between [South Tahoe] and our Firm'" and that it had "'been pleased to provide labor advice to you for the last 9 years.'" (Opinion, p. 7.)

Sheppard then suggested bifurcating South Tahoe's claim and requiring J-M to obtain separate counsel for that portion. (Opinion, p. 7.) It urged that there was no "significant downside" even though Sheppard had previously advised J-M that bifurcation was against J-M's interests. (1AA196, ¶¶ 27-28; 235-236, 239.) J-M declined. (Opinion, p. 8.)

The district court disqualified Sheppard. (*Ibid.*) It rejected Sheppard's argument that it could unilaterally drop South Tahoe as a client, noting that a published decision had disapproved Sheppard's attempt to use that very tactic in another case. (Opinion, p. 7 [citing *American Airlines, Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 Cal.App.4th 1017, 1037].)

E. *Sheppard vs. J-M.*

1. The trial court compels arbitration.

Sheppard sued J-M for unpaid legal fees arising from the qui tam representation. (Opinion, p. 8.) J-M cross-complained for damages and disgorgement. (*Ibid.*; 1AA8-27.)

Sheppard petitioned for an order compelling arbitration under the engagement agreement's arbitration provision. (Opinion, p. 8; 1AA41-53, 202.) J-M opposed, arguing the entire agreement containing the arbitration provision was void as against public policy. (Opinion, p. 8.)

The trial court compelled arbitration. (*Ibid.*) J-M's writ petition challenging that order was denied. (Opinion, p. 9.)

2. The arbitration.

The arbitrators did not decide whether the engagement agreement was illegal. (*Ibid.*) Their award observed that "'the better practice would have been [for Sheppard] to disclose the full South Tahoe situation to J-M and seek J-M's waiver of it.'" (*Ibid.*) "But the arbitrators concluded that they need not decide whether

[Sheppard's] failure to seek such a waiver constituted an ethical violation, and for purposes of their analysis assumed that the ethical violation occurred." (*Ibid.*) The arbitrators then concluded that compensation-forfeiture was not automatic and awarded Sheppard $1,118,147 in unpaid fees. (Opinion, pp. 9-10.)

The trial court confirmed the award. (Opinion, p. 10.)

3. The Court of Appeal decision.

The Court of Appeal unanimously reversed the trial court's order compelling arbitration.

First, it recognized that the court failed to decide J-M's challenge to the legality of the entire contract. (Opinion, pp. 2, 11-16.)

Second, applying long-established principles, it held that the entire agreement was illegal and thus, that the parties should never have been compelled to arbitration. (Opinion, pp. 11-22.) It held that (a) Sheppard violated its ethical duty by failing to disclose conflict information known to Sheppard; (b) this violation presented a public policy issue of "paramount concern" to the public trust in the administration of justice and the integrity of the Bar; and (c) the public policy violation struck at "the very foundation of an attorney-client relationship" created by the agreement and permeated the relationship, thus rendering the entire agreement illegal and unenforceable. (Opinion, pp. 16-26.)

Third, applying well-established law regarding actual conflicts, the court held that Sheppard was not entitled to its fees for work it performed while the actual conflict existed. (Opinion, pp. 29-31.) It remanded so that the trial court could determine whether the conflict existed when J-M signed the engagement agreement or a few weeks later when Sheppard resumed active work for South-Tahoe. (Opinion, pp. 30-31.)

ARGUMENT

I. CALIFORNIA STATUTES AND CASELAW MAKE CLEAR THAT NO "LIMITED," "DEFERENTIAL" STANDARD APPLIES TO THE PURELY JUDICIAL QUESTION OF THE LEGALITY OF AN ENTIRE CONTRACT CONTAINING AN ARBITRATION PROVISION.

A. As Statutes Dictate, California Courts Determine The Judicial Question Of *Entire* Contract Illegality De Novo But Are Deferential When Reviewing An Arbitrator's Determination Of *Partial* Contract Illegality.

Sheppard insists that California has *always* severely circumscribed courts' determination of the legality of an entire contract that contains an arbitration provision—that it is established that deference to arbitration awards prohibits courts from invalidating the contract unless it violates a *statutory* public policy, rather than a regulation or other source of law. (OBM, pp. 12-26 ["wall of authority" purportedly supporting Sheppard; J-M's supposed "misreading" of authority].)

Sheppard's argument is founded on confusion of two very different issues—the deferential review of an arbitrator's determination of a challenge to the legality of a *portion* of a contract, as opposed to a court's determination of the threshold challenge to the legality of an *entire* contract before deciding whether the matter should go to arbitration. As explained below, the arbitration statutes and an unbroken chain of California decisions are explicit on the distinction and governing standards: The court's analysis in the latter setting does not and cannot defer to the arbitrator's determination, so there is no limitation on the court's ordinary exercise of determining contract validity.

Supreme Court and Court of Appeal decisions explain this. The statutes applicable to the respective types of challenges demand it. And a contrary conclusion would allow parties to violate fundamental public policy by inserting an arbitration clause into an illegal contract.

1. *Moncharsh* recognizes that courts must decide entire-illegality and provision-illegality challenges at different stages and under different standards.

a. *Moncharsh*'s enunciation of the two standards.

Moncharsh, supra, 3 Cal.4th at pp. 31-33 took pains to "contrast" the two types of challenges and the different standards governing them.

Moncharsh's central holding was that an arbitrator's determination is ordinarily immune from claims of legal or factual error—"arbitral finality" precludes such challenges. (*Id.* at pp. 8-14.) But turning to judicial review of claims of illegality, the Court emphasized that the "'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 present. (*Id.* at p. 31, italics in original.) Thus, California law "permitted judicial review of an arbitrator's ruling where a party claimed the entire contract or transaction was illegal." (*Id.* at p. 32.) As the decision then indicates, the Court meant that where the question is the legality of the entire contract, judicial review is not limited:

The Court noted that the case before it did not involve entire-illegality. The *Moncharsh*-appellant "challenges but a single provision of the overall employment contract. Accordingly [California law does not] authorize[] judicial review of his claim"—that is, the normal rule of limited review of an arbitration award applies. (*Ibid.*)

In the very next sentence, the Court set forth the narrower form of judicial review applicable to such provision-illegality challenges: "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.* Such cases would include those in which granting finality to an arbitrator's decision would be inconsistent with the protections of a party's statutory rights." (*Ibid.*, italics added.)

The decision repeats this in its conclusion. "[T]he normal rule of limited judicial review 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.)

Moncharsh thus makes the analytical distinction crystal clear.

b. *Moncharsh*'s explanation of the statutory underpinnings of the two rules.

Moncharsh also explains different statutes and policies drive the differing standards for the two types of challenges.

Provision illegality. *Moncharsh* noted that provision illegality is decided by arbitrators, and thus judicial review of that determination is narrowly circumscribed by Code of Civil Procedure sections 1286.2 and 1286.6:

- Parties bargain for the arbitrator's determination of arbitrable disputes. (*Id.* at pp. 8-14.) Through the vacatur and correction statutes (section 1286.2 and 1286.6), the Legislature expressed a policy in favor of "arbitral finality," requiring the arbitrator's determination of arbitrable issues to stand immune from ordinary claims of legal error. (*Ibid.*)

- Provision illegality is an arbitrable issue. (*Id.* at p. 30 [when "alleged illegality goes to only a portion of the contract . . . the issue of illegality, remains arbitrable"].) The Legislature thus intended that the arbitrator's determination of provision-illegality to be final and section 1286.2 mandates imposition of the "normal rule of limited judicial review" when a provision's illegality is challenged. (*Id.* at pp. 32-33.)
- *Moncharsh* recognized a narrow exception to that "normal rule" when "according finality to the arbitrator's decision" regarding the legality of a "provision of the contract" violates a "statutory right." (*Id.* at p. 33.)

Entire illegality. A different set of statutes and policies apply to challenges to the legality of the entire contract containing an arbitration provision. "'[T]he rules which give *finality* to the arbitrator's determination of ordinary questions of fact or of law are *inapplicable*" to such challenges. (*Id.* at p. 31, italics added.).

- Entire illegality is *not* an arbitrable issue. Instead, trial courts must decide it when ruling on a petition to compel arbitration. (*Id.* at pp. 29-30.) Because arbitrators do not decide the issue, there is no "final" arbitral ruling on entire-illegality that requires limited judicial review. (See pp. 7-8, *ante* [arbitrators here did not decide issue].)
- Courts adjudicate entire illegality based on Code of Civil Procedures sections 1281 and 1281.2, governing petitions to compel arbitration—not the vacatur statute. (*Id.* at p. 29.) Section 1281.2 requires that a court deny arbitration if "'[g]rounds exist for the revocation of the agreement,'" and *Moncharsh* explained that "section 1281 states 'A written agreement to submit to arbitration an existing controversy . . . is valid . . . save upon such grounds as exist for the

> revocation of *any contract*.'" (*Ibid.*, italics altered, ellipses in original.) "If a contract includes an arbitration agreement, and grounds exist to revoke the entire contract, such grounds would also vitiate the arbitration agreement." (*Ibid.*) *Moncharsh* consequently determined that the "Legislature must have meant" that "if an otherwise enforceable arbitration agreement is contained in an illegal contract, a party may avoid arbitration altogether." (*Ibid.*)

A petition to compel arbitration "in essence, requests specific performance of a contractual agreement to arbitrate the controversy." (*Green v. Mt. Diablo Hospital Dist.* (1989) 207 Cal.App.3d 63, 69, cited approvingly by *Moncharsh, supra*, 3 Cal.4th at p. 30.) But trial courts have no power to enforce entirely illegal contracts. And the standard for judicial determination of that question is whether there exist "grounds for revocation of *any* contract." As Sheppard concedes, courts routinely look to all sources of law in determining whether an agreement is void as against public policy. (OBM, pp. 21-22; Opinion, pp. 24-26 [citing relevant cases].) Indeed, the Legislature has specifically directed courts to invalidate contracts that are "(1) Contrary to an express provision of law; (2) Contrary to the policy of express law, though not expressly prohibited; or (3) Otherwise contrary to good morals." (Civ. Code, § 1667.)

Indeed, the very concept of deference to the arbitration award is nonsensical in the context of a challenge to the legality of the entire contract. When a trial court decides that issue as part of a petition to compel arbitration—pre-arbitration—the trial court *cannot* review an arbitrator's determination; there aren't any arbitral determinations at that point. Finality cannot be afforded to an award that does not yet exist. And appellate courts can review the trial court's decision either before or