

Professional Responsibility

Are Advance Conflict Waivers Dead in California, and What Are the Penalties for Proceeding with an Unenforceable Advance Waiver? A Look at *Sheppard Mullin*.

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Introduction

This past week, the California Supreme Court issued its highly anticipated decision in *Sheppard Mullin v. J-M Industries*, ___ Cal. 4th ___, 2018 WL 4137013 (August 30, 2018). In that case the Court considered whether an advance conflict waiver in a law firm's engagement agreement was effective, and, if not, whether to affirm the court of appeal's wide-reaching holding that an invalid advance conflict waiver in an engagement agreement automatically invalidates the arbitration clause in that agreement and requires a disgorgement of all attorneys' fees.

In a lengthy decision, the California Supreme Court mostly agreed with the lower court. It found that the advance waiver in the parties' engagement agreement was ineffective and improper because the law firm knew about the "conflicting" representation at the time it proffered the agreement but failed to disclose the conflict.

Given the conflict, the Court found that the entire engagement agreement—including the arbitration and attorneys' fee provisions—was ineffective. The Court slightly softened this blow by refusing to adopt the lower court's bright-line rule automatically barring *all* compensation to lawyers who perform services pursuant to an improper conflict waiver. Instead, it found that if the lawyer could demonstrate good faith and non-egregious conduct, a court sitting in equity might allow *some* compensation to the lawyer despite the conflict of interest—although it contemplated that the recovery might not make the lawyer whole.

While the Court left open whether an advance conflict waiver might be enforceable in other factual situations, the opinion demonstrates the danger of relying on an advance waiver in California. Certainly, following *Sheppard*, a California attorney *must* make a written disclosure, and obtain a specific waiver, of any current conflicts when entering into a new engagement. While *Sheppard* does not address whether a lawyer must *go back* to a client who previously signed an advance waiver to get a specific waiver once new conflict information becomes available, clearly this would be the best and most prudent practice. In other words, until there is further guidance, it would be perilous for a California lawyer to rely on a generalized advance waiver when sufficient information is available to allow the lawyer to seek a specific waiver.

Background

In March 2010, Sheppard, Mullin, Richter & Hampton LLP (Sheppard) agreed to represent J-M Manufacturing Company, Inc. (J-M) in a qui tam action brought by a number of public entities. *Sheppard*, 2018 WL 4137013 at *1. One of those public entities was South Tahoe Public Utility District (South Tahoe), a long-time (albeit small) firm client. *Id.* Sheppard claimed that it was not doing any work for South Tahoe at the time it was engaged by J-M, but the Supreme Court found that South Tahoe was a current client when Sheppard was engaged. *Id.* There is no dispute that shortly after

Sheppard was engaged by J-M, Sheppard undertook about 12 hours of work for South Tahoe on unrelated employment law matters. *Id.* at *2.

Before entering into the J-M engagement, Sheppard identified the South Tahoe conflict. *Id.* at *1. Rather than seeking specific waivers from J-M or South Tahoe, Sheppard decided to rely on the advance waiver language in South Tahoe's agreement, and include the same language in J-M's agreement. *Id.* The signed J-M agreement provided, *inter alia*,

“We may currently or in the future represent one or more other clients (including current, former and future clients) in matters involving [J-M]. We undertake this engagement on the condition that we may represent [such] other client ... provided the other matter is not substantially related to our representation of [J-M] and in the course of representing [J-M] we have not obtained confidential information of [J-M] material to representation of the other client. By consenting to this arrangement [J-M] is waiving our obligation of loyalty to it so long as we maintain confidentiality and adhere to the foregoing limitations.”

Id. at *2.

South Tahoe eventually learned of the conflict and in May 2011 brought a successful motion to disqualify Sheppard. *Id.* at *3. At that point, Sheppard had been paid approximately \$2 million by J-M and was owed approximately \$1 million more. *Id.* at *3.

Sheppard sued J-M for its unpaid bills, and J-M cross-complained for disgorgement of the fees it had paid.^[1] *Id.* The matter was referred to arbitration in accordance with an arbitration clause in the engagement agreement, and the arbitrator ruled for Sheppard. *Id.* In doing so, the arbitrator noted that the conflict had not caused J-M any damage, prejudiced J-M's defense of the qui tam action, resulted in communication of confidential information to South Tahoe, or rendered Sheppard less effective. *Id.*

On appeal, the court of appeal found that the undisclosed conflict violated California's Professional Rule of Conduct 3-310(C)(3)^[2] and rendered the parties' agreement to arbitrate unenforceable. *Id.* The court further held that its finding that a conflict of interest existed categorically barred Sheppard from retaining any compensation for the work it performed for J-M. *Id.*

Summary and Analysis of Opinion

The Advance Conflict Waiver: The California Supreme Court expressly stated that it did not decide the broader issue of “whether, or under what circumstances,” an advance waiver may be enforceable. *Id.* at *12. Instead, it framed the issue presented as whether a lawyer could knowingly fail to disclose a known conflict. The court stated: “Because this case concerns the failure to disclose a current conflict, we have no occasion here to decide whether, or under what circumstances, a blanket advance waiver . . . would be permissible.” *Id.* Thus framed, the Court determined that Sheppard had breached its duty of loyalty.

In reaching this conclusion, the Court pointed out that the advance waiver—which stated that Sheppard “*may currently or in the future represent . . .*” a client with conflicting interests (*id.* at *1 (emphasis added))—was misleading because Sheppard knew that it *presently* represented a client who was adverse to J-M, and yet it failed to disclose this information to J-M.

While the Court stated that its opinion did not address the efficacy of advance waivers in general, the opinion clarifies that an advance waiver is not adequate if the conflict was known at the time the advance waiver was signed. In other words, according to *Sheppard*, when a firm takes on a new client or client matter, and a search reveals that the firm represents a different client (in an unrelated matter) with adverse interests, at that point a law firm has an obligation to provide a detailed disclosure to the “new” client and obtain a specific waiver.

Does a lawyer also have an obligation to obtain a specific waiver from an existing client who previously signed an advance waiver?^[3] Unlike the situation with J-M, when South Tahoe gave its advance waiver there was no known conflicting representation and thus nothing was concealed from South Tahoe. Also,

would J-M's advance waiver have been effective if (as Sheppard contended) South Tahoe was not a current client at the time of the engagement, but became a client again shortly thereafter?

Sheppard does not directly answer these questions, but it does make broad statements about the requirement of candor in the attorney-client relationship. See *id.* at *10 (“the disclosure required for informed consent to dual representation” is the “core aspect of the duty of loyalty” and “knowingly withhold[ing] material information about a conflict” is contrary to the duty of loyalty) and *18 (“maintaining trust and confidence “requires an ethical attorney to display all possible candor in his or her disclosure of circumstances that may affect the clients’ interests.”). Also of possible note, the Court distinguished a federal disqualification case from Texas, *Galderma Laboratories v. Actavis Mid Atlantic LLC*, 927 F. Supp. 2d 390 (N.D. Tex. 2013), which upheld an advance waiver. The *Sheppard* Court explained that the waiver in *Galderma* had been given prior to the time a conflict emerged, but also observed that “whether or not the district court in that case correctly interpreted and applied the Model Rules, California has not adopted those rules or, more importantly, the comments to them.” *Sheppard*, 2018 WL 4137013 at *11.

Finally, *Sheppard* briefly noted that comment 9 to Rule 1.7 (dealing with conflicts of interest) of California's revised Rules of Professional Conduct provides that the rule “does not preclude an informed written consent[] to a future conflict in compliance with applicable case law.” *Id.* at *11 n.7. Thus, *Sheppard* leaves the door open to finding advance waivers to be effective when done properly, but its emphasis on disclosure suggests that California courts will continue to scrutinize them carefully.

The Arbitration Clause: The Court found that Sheppard's engagement agreement with J-M “was entered under terms that undermined an ethical rule designed for protection of the client as well as for the preservation of public confidence in the legal profession,” and therefore it was unenforceable in its entirety. *Id.* at *12. Accordingly, the arbitration clause in the agreement was unenforceable.

Disgorgement of Fees: Having found that the engagement agreement was unenforceable in its entirety, the Court concluded that Sheppard had no valid contractual claim for unpaid services, nor did it have a right to keep the contractual fees it had earned. *Id.* at *13.

The harder question for the Court was whether Sheppard might have a claim in quantum meruit for its 10,000 hours of work. With one strong dissent, the Court refused to endorse a “bright-line rule barring all compensation for services performed subject to an improperly waived conflict of interest, no matter the circumstances surrounding the violation.” *Id.* at *17; see also *id.* at *22-31 (Chin, J., dissenting).

Instead, the Court held that an attorney who performed legal services “under the cloud” of a conflict, may, in the trial court's discretion and as a matter of equity, obtain some quantum meruit recovery if:

- The attorney shows that “the conduct was not willful, and its departure from ethical rules was not so severe or harmful as to render its legal services of little or no value to the client.” *Id.* at *14.
- The trial court is satisfied that the award does not undermine incentives for compliance with the Rules of Professional Conduct. *Id.* at *18.
- The attorney proves the value of the work “in light of the harm done to the client and to the relationship of trust.” *Id.* at *14.

Finally, the Court directed that, “absent exceptional circumstances,” the fee agreement is not an appropriate measure for recovery. *Id.* at *18. **Indeed, the Court expressly contemplated that the lawyer would not be made “whole” by any quantum meruit recovery.** It stated: “Although the law firm may be entitled to some compensation for its work, its ethical breach will ordinarily require it to relinquish some or all of the profits for which it negotiated. *Id.*

The Court remanded the case to the trial court for a quantum meruit determination in conformance with the Court's directions. *Id.* at *18-19. It stated that if the trial court concluded that the firm was “legitimately confused” when it provided J-M with the advance waiver or was otherwise acting in good faith, and its conduct caused no harm or only nominal harm, some compensation might be

appropriate. *Id.* If, on the other hand, the trial court found the firm’s misconduct was egregious or potentially harmful, an award would be precluded. *Id.*

[1] The issue presented was a “duty of loyalty”; Sheppard never represented South Tahoe in any matter related to the quiet title action, or in any matter where South Tahoe was adverse to J-M. *Id.* at *2-3.

[2] Rule 3-310(C) will remain in effect until November 1, 2018, when it will be replaced with revised Rule 1.7, as explained further below.

[3] While the *Sheppard* Court was not called on to address whether the advance waiver given by *South Tahoe* was enforceable, presumably the trial court had found the advance waiver in South Tahoe’s engagement agreement was unenforceable when it made the disqualification order.

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