Insights

INSIGHT: Client Consent to Future Conflicts Will Not Apply Where Disclosure Is Inadequate: Lessons from The Sheppard Mullin Case

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On August 30, 2018, in a long-awaited decision, the California Supreme Court weighed in on a question of increasing significance to law firms: under what circumstances will a conflict waiver contained in an initial client engagement agreement be deemed enforceable when a conflict of interest might arise *later* in the firm's representation of a different client? *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., Inc.*, 425 P.3d 1 (Cal. 2018). The decision provides some important lessons for law firms on the use of prospective conflict waivers.

Background

In 2010 J-M engaged the Sheppard Mullin law firm in defending it in a *qui tam*/whistleblower action being prosecuted by approximately 200 public entities around the country. The basis of the claim was that J-M had made misrepresentations in its sale of polyvinyl chloride pipe to the claimant entities. The firm ran a conflicts check to determine whether it had previously, or was currently, representing any of the public entities identified as the real parties in interest in the *qui tam* action. The conflicts check showed that another firm attorney had done employment-related work for one of the public entities (South Tahoe Public Utility District) on and off since at least 2002, and most recently in 2009. Another firm represented South Tahoe in the *qui tam* action.

The engagement agreement between the firm and South Tahoe for the employment matters contained an advance waiver of conflicts, at least with respect to cases unrelated to employment matters. According to the court, "after internal consultation, Sheppard Mullin's general counsel opined that because of this advance conflict waiver [by South Tahoe], the firm could take on representation of J-M in the [unrelated] qui tam action." *Id.* at 6.

Wording of the Advance Conflict Waiver at Issue

When J-M entered into an engagement agreement with the firm for the defense of the *qui tam* action, the agreement included a conflict waiver similar to the one in the engagement agreement South Tahoe had signed when it had engaged the firm years before for the unrelated employment matters.

The waiver provision in the J-M agreement provided, in part, as follows:

"Conflicts with Other Clients . . . We undertake this engagement on the condition that we may represent another client in a matter in which we do not represent [J-M], even if the interests of the other client are adverse to [J-M] (including appearance [sic] on behalf of another client adverse to [J-M] in litigation or arbitration . . . *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 limitation."

The Disqualification Motion by the "Dormant" Client

As it happened, a few weeks after the firm began its representation of J-M in defense of the *qui tam* action, the firm partner handling employment matters for South Tahoe began actively working on a new matter—unrelated to the *qui tam* action—for that client. Over the course of the year, the firm billed South Tahoe for about 12 hours of work.

Having become aware that the firm was representing J-M, South Tahoe's counsel in the *qui tam* action wrote to the firm complaining that the firm had failed to specifically inform South Tahoe that the firm had taken on the representation of J-M in a matter adverse to it. According to the court: "Sheppard Mullin responded by reminding South Tahoe of its earlier conflict waiver. Dissatisfied with this response, South Tahoe filed a motion to disqualify [the firm] in the qui tam proceeding." *Id.* at 7.

The trial court in the *qui tam* action, rejecting the firm's defense based on South Tahoe's signed prospective conflict waiver, granted South Tahoe's motion to disqualify the Sheppard Mullin firm from continuing to represent J-M in the case.

The Fee Dispute with the "Active" Client

That was not the end of the firm's troubles. With the trial court having ruled that a similar version of the firm's advance conflict waiver was ineffective in the firm's engagement agreement with *South Tahoe*, the firm then faced a separate challenge that the waiver provision was ineffective in its engagement agreement with *J-M*. Worse yet, having been disqualified on South Tahoe's request from performing any further work for J-M in the *qui tam* case, the firm was left with J-M's unpaid invoices of approximately $1.3 million for work in the case. So the firm sued J-M to collect the unpaid fees. In response, J-M not only asserted it was excused from paying the unpaid account balance. It went further, arguing that because of the firm's failure to disclose its representation of South Tahoe in the unrelated employment matters, it was entitled to a return of the approximately $2 million it had *already* paid the firm.

Is the Client Who Signed the Conflict Waiver with Insufficient Information Later Excused from Paying Fees?

J-M's position in the fee collection action put into issue, among other questions, whether under California law, a law firm's *entire* client engagement agreement

will be deemed unenforceable, including the firm's contractual right to be paid, when a conflict waiver is deemed inadequate. It was the firm's collection claim against J-M that landed at the California Supreme Court.

With respect to the enforceability of the advanced conflict waiver, the Sheppard Mullin firm, together with several national law firms that filed amicus briefs, acknowledged that the firm's simultaneous representation of the two clients on unrelated matters was covered by the conflict of interest provisions of the California Rules of Professional Conduct. But they argued that by agreeing to the advance conflict waiver provision in the engagement agreement, J-M had given its informed consent to the concurrent representation of the existing client (South Tahoe) in an unrelated matter.

The California Supreme Court rejected this argument on the facts presented. It pointed to the undisputed fact that at the time the firm agreed to represent J-M in the defense of the *qui tam* action, the firm *already* was representing the adverse client (South Tahoe). Accordingly, said the court, the firm was "required . . . to disclose to J-M the fact that a current conflict *actually* existed. . . .Sheppard Mullin's blanket waiver would not be effective in this case. . .because. . .the law firm failed to disclose a known, existing conflict before soliciting J-M's consent." *Id.* at 16, 17 (emphasis added).

It was for this reason the court expressly declined to address "whether, or under what circumstances, a blanket advanced waiver. . .would be permissible." It instead held "[t]hat without full disclosure of *existing* conflicts known to the attorney the client's consent is not informed for purposes of [the] ethics rules." *Id.* (emphasis added).

The Law Firm's Failure to Obtain Adequate Consent to the Conflict

Having found that, under the circumstances, the firm should not ever have asked the client (J-M) to sign the advance conflict waiver provision, the court went on to address whether the engagement agreement was unenforceable *in its entirety*; even, as the court itself acknowledged, in the absence of evidence that the client had suffered any material prejudice "as a result of" the firm's inadequate description of the conflict. *Id.* at 18. The court concluded the entire agreement was unenforceable. And this meant the firm was not entitled to collect the fees the client then owed, at least in reliance on the hourly rate calculation in the engagement agreement. However, the court held that on remand to the trial court, notwithstanding the firm's violation of its obligations under the conflict rules, the firm would be permitted to pursue a recovery under a quantum meruit theory for the value of the services it had provided to the client.

Lessons Learned

The California Supreme Court's decision in the *Sheppard Mullin* case does not represent a death knell to law firm advance conflict waiver provisions. However, the decision warns law firms not to reflexively rely on such provisions when it currently is aware of adversity between an *existing* client and the new client or of potential adversity between the clients that the firm reasonably should foresee.

Other lessons from the decision include:

■ A law firm cannot assume that the sophistication of the client in question necessarily means that the client's consent was "informed" within the meaning of the conflict of interest rules. And this includes the circumstance where, as in the *Sheppard Mullin* case, the client's own in-house attorney signed the advance conflict waiver. "No matter how large and sophisticated, a prospective client does not have access to a law firm's list of other clients and cannot check for itself whether the firm represents adverse parties. Nor can it evaluate for itself the risk that it may be deprived, via [a] motion for disqualification, of its counsel of choice, as happened here." *Id.* at 17.

■ A law firm cannot excuse the failure to specifically disclose its relationship with a party directly adverse to the new client by characterizing the adverse client, as the Sheppard Mullin firm did, as a "dormant" client. If there is any basis to conclude that, at the time the challenged conflict waiver provision was entered into, the firm had an *existing* attorney-client relationship with a client whose interests were directly adverse to the new client (even if the contemplated new representation involved an unrelated matter), both clients are likely to be deemed "concurrent" within the meaning of the conflict of interest provisions of the Rules of Professional Conduct.

■ Law firm risk managers and general counsel must emphasize that, as with any provision in the firm's "standard" client engagement agreement, an advance conflict waiver provision cannot be a "one size fits all" proposition. The standard procedure should be that if a conflict search discloses the existence of an open (including a "dormant") matter for a client with interests *directly* adverse to the prospective client, even if the subject of the firm's existing representation of the other client is unrelated, the firm will not take on the new client matter without first providing full disclosure to the client and obtaining an *individualized* conflict notice and consent.

■ In Comment [22] to Rule 1.7 of the Model Code of Professional Conduct ("Conflict of Interest: Current Client"), the ABA has given a tepid endorsement of prospective conflict waivers, at least where ". . .the client reasonably understands the material risks that the waiver entails and whose consent therefore is 'informed' within the meaning of Model Rule 1.7(b)(4)." And, according to the ABA authors, the determination of whether the client has the "requisite" degree of understanding, and therefore whether the consent to a future conflict is valid, will depend in each circumstance on such factors as: (a) how detailed and "comprehensive" the lawyer's explanation of what presently unknown future client representations "might arise" in light of the client's relative sophistication and experience in using legal services; (b) consent is limited with respect to the subject matters of future representations and is not "open-ended" in duration; and (c) the conflict that materializes down the road is one that would be a consentable conflict under Rule 1.7(b) in the first place.

■ The *Sheppard Mullin* case is another in a growing number of cases reflecting judicial skepticism of, if not outright hostility to, prospective conflict waivers that are unlimited in scope or in duration. In a footnote, the court in the *Sheppard Mullin* case cited to three such decisions (each applying the California ethics rules): *Lennar Mare Island, LLC v. Steadfast Insurance Co.*, 105 F.Supp. 3d 1100, 1118 (E.D. Cal. 2015) (granting motion to disqualify and rejecting firm's reliance on an advance conflict waiver that: (a) left the firm " 'free to

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represent any other client either generally or in any matter in which [the client] may have an [adverse] interest' "; and (b) applied, without any limitation, to litigation on any subject); *Western Sugar Cooperative v. Archer-Daniels-Midland Co.*, 98 F.Supp. 3d 1074, 1081-84 (C.D. Cal. 2015) (waiver invalid because it was too open-ended and failed to advise the client of the names of potentially adverse clients or the types of possibly adverse engagements); and *Concat LP v. Unilever, PLC*, 350 F.Supp. 2d 796, 819-21 (N.D. Cal. 2004) (waiver invalid because it was nonspecific and overbroad in both scope and subject matter). Another example is a Bankruptcy Court's recent ruling barring a law firm's representation of debtors in a high profile licensing dispute adverse to its client Netflix. *In re Relativity Media, LLC*, 2018 WL 3769967 *5 (Bankr. S.D.N.Y. July 6, 2018) (rejecting law firm's reliance on an advance conflict waiver that was not "sufficiently clear and specific" that the conflicts to which Netflix had consented were the same conflicts created by the firm's representation of the debtors "in their present disputes with Netflix").

■ The decision in the *Sheppard Mullin* case highlights another factor bearing on the enforceability of a prospective conflict waiver: the sufficiency of the firm's discussion with the client, not only at the outset of the engagement, but at the time a conflict actually materializes. Rather than merely assuming the prospective conflict waiver is self-executing, a firm should ask the client to reaffirm its assent to the waiver at precisely the time the unforeseen becomes manifest: the firm's engagement by a different client with interests adverse to the existing client. The client's initial consent to future conflicts is far more likely to be deemed "informed" if the firm makes the effort to revisit the waiver in light of the circumstances that actually develop.

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