

Expert Analysis

Calif. Ruling Dings Engagement Letter Arbitration Clauses

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The recent California Supreme Court decision in *Sheppard Mullin v. J-M Manufacturing*^[1] has received a great deal of attention over its holding on the validity of a broad and nonspecific waiver of conflicts. Far less attention has been given to the court's holding that in cases involving a conflict of interest, the entire engagement agreement, including the arbitration clause, is unenforceable as against public policy.

This aspect of the decision is likely to have some very practical consequences in the trial courts in California, including the potential for enormous delays in the resolution of fee disputes and malpractice claims. It may well cause law firms to reconsider the use of arbitration clauses in engagement agreements — or, ironically, it may increase the prevalence of such clauses.

The Sheppard Mullin Decision

Sheppard Mullin represented J-M in a federal *qui tam* action brought on behalf of a number of public entities. During the same time period, Sheppard Mullin also represented one of these public entities in matters unrelated to the *qui tam* suit. Both clients had executed engagement agreements that included general waivers of all conflicts of interest, current or future. The waivers, however, did not specifically refer to any existing conflict.

The public entity discovered the conflict, and successfully moved to disqualify Sheppard Mullin in the *qui tam* action. At that time, the firm's billings in the *qui tam* action totaled more than \$3 million, of which more than \$1 million remained unpaid. Sheppard Mullin then sued J-M for unpaid fees. J-M cross-complained for breach of contract and other claims. It also sought disgorgement of fees previously paid to Sheppard Mullin, as well as exemplary damages.

Because J-M's engagement agreement with Sheppard Mullin contained an arbitration clause, Sheppard Mullin petitioned to compel arbitration. The superior court granted the petition, and the arbitrators ruled in favor of Sheppard Mullin after a full evidentiary hearing. The superior court confirmed the award, but the court of appeal reversed.

The court of appeal concluded that the matter should never have been arbitrated, because Sheppard Mullin's conflict of interest rendered the engagement agreement, including the



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arbitration clause, unenforceable in its entirety. The court further held that Sheppard Mullin's conflict of interest disentitled it from receiving any compensation whatsoever for the work it performed for J-M while also representing the public entity in other matters. The California Supreme Court granted Sheppard Mullin's petition for review.

The Supreme Court agreed with the Court of Appeal that Sheppard Mullin's undisclosed conflict of interest violated the requirements imposed by rule 3-310(C)(3) of the Rules of Professional Conduct. This rule (which has recently been modified in the updated rules) provided that an attorney "shall not, without the informed written consent of each client ... [r]epresent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter."

The Supreme Court concluded that the conflict waiver that J-M signed was not effective, because Sheppard Mullin had failed to disclose a known conflict with a current client.[2] The court ruled that this ethical violation rendered the engagement agreement with J-M, including its arbitration clause, unenforceable as against public policy.[3]

Contrary to the Court of Appeal, the California Supreme Court concluded that Sheppard Mullin's ethical violation did not categorically disentitle the law firm from recovering the value of the services it rendered to J-M, and sent the case back to the trial court to address whether principles of equity entitle Sheppard Mullin to some measure of compensation.[4]

Observations

By holding that the arbitration clause in the engagement agreement is unenforceable based on a conflict of interest, the California Supreme Court may have created a procedural morass for trial courts and litigants in future malpractice cases and fee disputes in California.

The Supreme Court has made any claim of conflict of interest a threshold issue to be determined by the trial court, at least on a preliminary basis. As a result, clients faced with a demand for arbitration in fee disputes or a motion to compel arbitration in malpractice cases can now put into doubt the validity of the arbitration agreement, or at least create a question as to the validity of an arbitration award, by asserting that the lawyer violated his or her ethical obligation by having a conflict of interest, or by failing to obtain an adequate waiver of conflicts.

The court will now be required to resolve the conflict allegations before any malpractice claim or claim for fees can go forward — in arbitration or the courts. That is likely to raise some issues that may not have been immediately apparent to the appellate courts in Sheppard Mullin.

Sheppard Mullin came to the appellate courts in an unusual posture. A fully litigated arbitration proceeding already had occurred. There was a complete evidentiary record. And the issue — the adequacy of the waiver and the firm's disclosure of an existing conflict — could be determined on a relatively uncontested set of facts. That will not always be the case. Indeed, it is not likely to be true in most cases in which a trial court is asked to decide a motion to compel arbitration, filed at the pleading stage of an action.

How is the trial court supposed to resolve the conflict issue at such an early stage? Would a decision on arbitration require resolution of the entire conflict issue on the merits? Does the trial court review declarations and documentary evidence as to whether there was a conflict, what was disclosed, whether the disclosures were adequate based on the information available at the time, and whether the alleged conflict was in any way material to the alleged malpractice? Does the court take live testimony?

Even under the best of circumstances, the situation calls for the trial court to resolve an issue that is central to the merits of the case on a limited record at what is effectively the pleading stage of the case. This decision thus creates the potential for enormous delays, particularly because the denial of a motion to compel arbitration is immediately appealable in California.

This means that defendants in fee disputes and malpractice cases have the option of appealing any denial of their motion to compel arbitration and obtaining an automatic stay, thus delaying further proceedings until the appeal is heard. This situation thus has the potential to delay discovery or litigation on the merits in malpractice and fee cases for one to two years.

While this delay may serve a defendant's interests, it is not likely to serve the interests of many plaintiffs. And it certainly does not serve the interests of justice, as memories will continue to fade as the appeal wends its way through the courts to determine the forum.

This problem is particularly troubling because, unlike the Sheppard Mullin case, most fee disputes and malpractice cases are not for \$3 million, and very few law firm engagement letters contain attorney's fees clauses. So the parties now must assume the costs of appellate litigation before ever reaching the merits of their respective claims. Many cases will not warrant that investment. As a result, plaintiffs in fee disputes and malpractice cases may decide not to enforce arbitration agreements, not to challenge a motion to compel arbitration or not to appeal a denial of a motion to compel arbitration, in order to avoid the delay and cost associated with an extended battle over the correct forum.

The Sheppard Mullin ruling likely will have an impact on many malpractice cases, because conflict of interest is frequently alleged in such cases. Particularly with the recent decision of *Knutson v. Foster*,^[5] which arguably changed the standard of causation in cases involving an alleged intentional breach of the duty of loyalty, conflict of interest claims likely will become even more common. Moreover, in *Sheppard Mullin*, the Supreme Court did not foreclose the possibility that other ethical violations by attorneys may render an arbitration agreement unenforceable if they go to the validity of the entire engagement agreement. The impact of the decision on fee and malpractice disputes therefore may reach beyond cases involving conflicts of interest.

The upshot here is that the California Supreme Court has thrown into doubt the enforceability of arbitration clauses in attorney engagement agreements, which may well disrupt the efficient and effective resolution of malpractice claims and fee disputes.

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[1] Sheppard Mullin Richter & Hampton LLP v. J-M Manufacturing Company Inc., 6 Cal.5th 59 (2018).

[2] Sheppard Mullin, 6 Cal.5th at 84-86.

[3] *Id.*, at 87.

[4] *Id.*, at 96.

[5] Knutson v. Foster, 25 Cal.App.5th 1075 (2018).