

Professional Liability Alert: California Supreme Court Decides that Ethical Violation Does Not Necessarily Result in Forfeiture of Fees

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In *Sheppard Mullin Richter & Hampton, LLP v. J-M Manufacturing Company, Inc.*, No. S232946, August 30, 2018, the California Supreme Court found that Sheppard Mullin's failure to disclose a known conflict with another current client did not categorically disentitle the law firm from recovering the value of the services it rendered to J-M Manufacturing.

In 2016, the Appeals Court had found that advance conflict waivers signed by J-M Manufacturing and another current client of the firm did not effectively waive the firm's conflict of interest. In light of this ethical violation, the Court of Appeals held that Sheppard Mullin was not entitled to keep any of the fees it had collected, or recover fees owed, the total of which amounted to nearly \$4 million for 10,000 hours of work over several years.

When the California Supreme Court agreed to review Court of Appeals decision, hopes were high that the Court would take the opportunity to provide guidance regarding the specificity required in advance waivers in order to make them enforceable. The Court didn't take that opportunity. But it did delineate in careful detail why even a serious ethical violation does not mean that a firm forfeits its right to be paid for the value of its services.

Background

Sheppard Mullin had been disqualified from defending J-M Manufacturing in a qui tam case alleging that J-M had misrepresented the strength of PVC piping supplied to over 200 public utilities. One of those public utilities was South Tahoe Public Utility District, which Sheppard Mullin had long represented in unrelated employment matters. Both before and after J-M engaged the firm in connection with the qui tam lawsuit, South Tahoe had signed advance waivers of conflicts adverse to the utility, but unrelated to the matters for which it engaged Sheppard Mullin. Similarly, when J-M engaged Sheppard Mullin, it too signed an advance waiver. Yet even though the conflict between South Tahoe and J-M Manufacturing was known to Sheppard Mullin when J-M engaged the firm, Sheppard Mullin did not disclose it when it documented the waiver with J-M or later when it confirmed a new advance conflict waiver with South Tahoe. Upon learning of the conflict, South Tahoe succeeded in disqualifying Sheppard Mullin from its representation of J-M Manufacturing in the qui tam case. After it was disqualified Sheppard Mullin sued J-M for unpaid fees, and J-M cross-claimed and sought disgorgement of the fees previously paid to Sheppard Mullin.

Decision

The Supreme Court concurred with the Court of Appeal that Sheppard Mullin's failure to disclose the existing conflict rendered the waivers unenforceable, but offered no guidance beyond that to help attorneys determine the correct level of disclosure or detail required when obtaining advance or other waivers. However, the Supreme Court disagreed with the Court of Appeals regarding Sheppard Mullin's right to retain paid fees and collect unpaid fees for its work for J-M Manufacturing. On that issue, the Supreme Court reversed the Court of Appeals, which had ordered disgorgement of all fees collected, and remanded the issue back to the trial court for further proceedings in accordance with its decision.

Rather than applying a bright line rule that a conflicted attorney can never collect or keep fees earned in connection with the matter, the Court decided that case specific factors must be taken into account in each case. Forfeiture of compensation is an equitable remedy and derives primarily from the general principle that a fiduciary's breach of trust undermines the value of his or her services. However, the Court found that even though the value of the unfaithful lawyer's services may be diminished, it is not necessarily eliminated in every case. Sheppard Mullin had never worked against J-M Manufacturing's interests in connection with its representation of South Tahoe. Further, there was no evidence that the firm breached its duty of confidentiality to either client. Indeed, J-M had stipulated that it was not challenging the value or quality of Sheppard Mullin's work. Under those circumstances, Sheppard Mullin argued that denying all compensation for the extensive legal services provided to J-M Manufacturing would impose a disproportionate penalty on the firm and a massive windfall for the client.

The Supreme Court held that because some value may remain in the services that were provided to the client, the law firm may be entitled to some or most of its fees. It further held that the law firm could seek fees on a *quantum meruit* basis, taking into consideration the gravity and timing of the violation, its degree of willfulness, its effect on the value of the lawyer's work for the client, and any threatened or actual harm to the client. The Court stated that the burden to prove the value of its services is on the law firm. The client is under no obligation to present evidence that it was injured, that any harm resulted from the violation, or that the conflict affected the value of work. In the end, the Court remanded the issue to the Superior Court to allow the firm to try to demonstrate that it had acted in good faith and show that its conduct had not harmed the client sufficiently to eliminate all value.

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