Of Conflicts and Corporations: Analyzing Corporate Forms for Future Litigation Finance Firms

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I. INTRODUCTION

Third-party litigation finance is part of legal scholarship's cutting edge. Proposals for enabling legislation have both ardent supporters and critics, but the idea has already gained traction in Australia and the United Kingdom.[1] It is worth noting that these countries differ from the United States in some respects.[2] However, the push for legalizing this practice appears to be gaining ground rapidly. In fact, several firms are already operating litigation finance operations in the United States.[3]

Current litigation finance firms operate as limited Guernsey corporations.[4] But these firms operate with the purpose of avoiding conflict with *existing* U.S. and U.K. law. This operating model may be inefficient.[5] In an ideal world—indeed, the one envisioned by litigation finance proponents—laws would allow plaintiffs to freely contract with these firms to finance their claims.[6] However, scholars have yet to consider what form these now-legal firms might adopt. This Note fills that void.

Part II analyzes litigation finance's history in the United States. I recount third-party financing's greatest obstacle—the ancient doctrine of champerty—and the modern workarounds to that rule. I also review the most recent scholarship relating to third-party financing to provide the context for understanding the evolving world in which these firms operate. Part III then analyzes several corporate structures litigation finance companies might choose. While current financing companies operate around existing laws, the options analyzed in this Part assume the underlying laws prohibiting third-party finance are removed. In considering these options, I weigh several sometimes-competing interests, including the ability to raise capital and potential conflicts between capital providers, financiers, and claimants. I conclude that a benefit corporation provides the ideal balance

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1. *See* John Emmerig & Michael Legg, *Litigation Funding in Australia: More Swings and Roundabouts as Lawyers Withdraw Application to be Funders*, JONES DAY (Feb. 2014), http://www.jonesday.com/Litigation-Funding-in-Australia-02-06-2014/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original (explaining that, in Australia, lawyers have been utilizing this system for years, yet are starting to withdraw as funders); Owen Bowcott, *Litigation Funders Become Big Business, Enjoying Booming Market in UK*, GUARDIAN (May 25, 2012), http://www.theguardian.com/law/2012/may/25/litigation-funders-booming-market-uk (reporting on the growth of third-party litigation funding in the UK).

2. For example, the contingency fee model, dominant in the United States, is illegal in Australia. Emmerig & Legg, *supra* note 1. Additionally, litigation in the UK is structured such that the losing party pays the winning party's attorney costs. *See generally* Winand Emons & Nuno Garoupa, *US-Style Contingent Fees and UK-Style Conditional Fees: Agency Problems and the Supply of Legal Services*, 27 MANAGERIAL & DECISION ECON. 379 (2006) (providing a discussion of contingency-style fees in the United States and United Kingdom).

3. Examples of these include Juridica Investments Ltd. and Buford Capital LLC.

4. *See, e.g.*, *Juridica Investments Limited*, GUERNSEY REGISTRY, https://www.greg.gg/webCompSearchDetails.aspx?id=7DCrzXkl2+Q=&r=0&crn=&cn=Juridica&rad=StartsWith&ck=False (last visited Mar. 14, 2016) (stating that Buford is also a Guernsey Registered Company); *Burford Capital Limited*, GUERNSEY REGISTRY, https://www.greg.gg/webCompSearchDetails.aspx?id=z38qtbbOG0U=&r=0&crn=&cn=burford&rad=StartsWith&ck=False (last visited Mar. 14, 2016) (providing company details for Juridica, including that it is a Guernsey Registered Company).

5. Recent scholarship proffered a model contract for these claims. *See* Maya Steinitz & Abigail C. Field, *A Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 749–71 (2014). However, scholars also note that this bargaining results in substantial transaction costs and overall system inefficiency. *See* Herbert Hovenkamp, *Fractured Markets and Legal Institutions*, 100 IOWA L. REV. 617, 620 (2015) (claiming that, in the automobile industry, bargaining is difficult and yields high costs).

6. *See generally* Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455 (2012) (arguing that third-party funders should be treated as interested parties in legal matters).

of conflict mitigation and access to capital.

II. CURRENT PROBLEMS WITH PLAINTIFF LITIGATION AND THE THIRD-PARTY FUNDING SOLUTION

Third-party financing is the latest in a series of developments that could change the landscape of civil litigation. In this Part, I trace litigation finance's development in the United States, including reference to its ancient roots in the English common law. From its early roots in the doctrine of champerty to the rise of the contingent fee model and insurance defense and prosecution, litigation looks very different today than it did at the country's founding. Next, I review modern developments in litigation finance, both in American legal scholarship and in foreign jurisdictions. If, and when, third-party finance takes hold in American litigation, the same forces that reshaped English and Australian laws will likely guide its development.

A. Champerty, Maintenance, and the Rise of the Contingent Fee Model

In the United States, plaintiffs and defendants pay their own legal costs in litigation.[7] This "American Rule" developed as a response to complaints of soaring legal costs, which became "altogether disproportionate to the magnitude" of their underlying claims.[8] This contrasts with the "English Rule," in which the losing litigant pays the winner's legal fees.[9] This Section tracks the development and divergence of these two systems and their reticence toward third-party financed litigation.

While the "English Rule" arose from English statutes (and thus never bound colonial jurisdictions), the doctrine of champerty was a common law rule that made it across the Atlantic. The champerty doctrine was founded on fears that "champertors will encourage frivolous litigation, harass defendants, increase damages, and resist settlement."[10] However, this has rarely been the case, and exceptions to champerty are commonplace.[11] In fact, champertous arrangements tend to increase plaintiffs' access to the courts.[12] Unsurprisingly, one of the biggest opponents to third-party finance is the U.S. Chamber of Commerce, which represents the interests of natural defendants to resource-poor plaintiffs.[13] Furthermore, despite the supposedly grave dangers of incenting frivolous litigation, American courts have largely embraced a different form of litigation finance—the contingency fee.[14]

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7. *See, e.g.*, John H. Vargo, *The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice*, 42 AM. U. L. REV. 1567, 1569 (1993) (stating the "American Rule").

8. *Id.* at 1577 (quoting CONG. GLOBE 32d Cong., 2d Sess. 207 (1853)).

9. *Id.* at 1569.

10. Susan Lorde Martin, *Financing Plaintiffs' Lawsuits: An Increasingly Popular (and Legal) Business*, 33 U. MICH. J.L. REFORM 57, 58 (1999).

11. *Id.*

12. *See id.* (noting that "without third party support some meritorious plaintiffs who lacked the financial wherewithal would not be able to litigate their claims"); *see also* Steinitz, *infra* note 14, at 1281 (noting that third-party funding is "desirable as a way of increasing access to justice").

13. Steinitz, *supra* note 6, at 484.

14. *See, e.g.*, Maya Steinitz, *Whose Claim is this Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1292 (2011) (discussing use of contingency fees in litigation finance). Steinitz notes, however, that the incentives created by contingency fees and third-party litigation finance, while similar in some regards, are different in others. *Id.* at 1293–95.

Additionally, and importantly, champerty is not even a defense against a lawsuit but merely a doctrine that makes champertous provisions unenforceable in a litigation finance contract.[15] This legal reality led many to question champerty's rationale, as frivolous litigation is not actually prohibited under the doctrine.[16] Those questions have grown into momentum toward courts repealing the doctrine and scholars calling for its abolition nationwide.

B. Current Trends in Litigation Finance

Recent scholarship has called on governments to enable third-party litigation finance. These calls have taken several forms. For example, some scholars have called for simply eliminating the doctrine of champerty and allowing third-party finance with little to no restriction;[17] some call for allowing plaintiffs to incorporate their claim as an SPV and distribute shares;[18] still others call for allowing secondary markets to buy and sell litigation risk.[19] This Section focuses primarily on arguments for and against enabling litigation finance, as this Note considers what form a firm financing litigation may take.[20]

Arguments against the doctrine of champerty are nothing new, and some states have embraced those arguments. The doctrine was abrogated in Massachusetts, where the state's Supreme Judicial Court held "the common law doctrines of champerty . . . and maintenance no longer shall be recognized."[21] Curiously, and in a footnote, the Massachusetts high court noted in dicta that its ruling "should not be interpreted to indicate our authorization of the syndication of lawsuits."[22] It is unclear what that means, though it is fair to say it at least illustrates a judicial mood more concerned about the efficient administration of the courts. Similarly, New York courts have opened the door to third-party finance. The New York Court of Appeals recently held "the champerty statute is violated by an attorney '*only* if the primary purpose of the purchase or taking by assignment of the thing in action is to enable the attorney to commence a suit thereon.'"[23]

While these state courts and others hedge on the champerty question, some foreign jurisdictions have tackled the issue head-on. The English Legal Services Act of 2007 deregulated that country's legal sector, resulting in the common law world's first publicly traded law firms.[24] Similarly, the High Court of Australia held in *Campbells Cash & Carry Pty Limited v. Fostif* that third-party finance was legal in that country.[25] In reaching this conclusion, the Australian court asked "what exactly is the corruption of the processes of

15. 7 WILLISTON ON CONTRACTS § 15.3 (4th ed. 1990).

16. *Id.*

17. *See, e.g.*, Steinitz, *supra* note 14, at 1327 (advocating for the abolition of the champerty doctrine).

18. *See* Maya Steinitz, *Incorporating Legal Claims*, 90 NOTRE DAME L. REV. 1155, 1162 (2015) (discussing ways to incorporate as an SPV).

19. *See generally* Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009) (discussing aspects of buying and selling litigation risk).

20. The best corporate form for a firm dealing in a secondary litigation market or originating a litigation SPV may not be the best form for a firm financing litigation. That analysis is not within the scope of this Note.

21. Saladini v. Righellis, 687 N.E.2d 1224, 1224 (Mass. 1997).

22. *Id.* at 1227 n.7.

23. Tr. for the Certificate Holders of Merrill Lynch Mortg. Inv'rs, Inc. v. Love Funding Corp., 918 N.E.2d 889, 894 (N.Y. 2009) (quoting Sprung v. Jaffe, 147 N.E.2d 6, 9 (N.Y. 1957)) (emphasis added).

24. *See* Legal Services Act 2007 (Eng.), http://www.legislation.gov.uk/ukpga/2007/29/pdfs/ukpga_20070029_en.pdf (allowing the creation of publically traded law firms).

25. *Campbells Cash & Carry Pty. Ltd. v. Fostif* (2006) 229 CLR 386 ¶ 93 (Austl).

the [Australian courts] that is feared?"[26] The *Fostif* court held any such concerns are "sufficiently addressed by existing doctrines of abuse of process and other procedural and substantive elements," and further that "there is no reason proffered for concluding that present rules regulating lawyers' duties to the court and to clients are insufficient."[27]

Scholars criticize American resistance to European and Australian progress as inefficient and unnecessary. On the inefficiency argument, scholars note that third-party funding can "enhance[] social welfare to the extent it can resolve the incentive divergence problem in the presence of high transaction costs between potential injurers and potential victims."[28] Scholars also note third-party funding's ability to "play for rules" to the same extent as repeat-players.[29]

As to champerty's unnecessity, scholars note that existing causes of action—such as malicious prosecution and abuse of process—make a ban on champerty unnecessary.[30] Similarly, scholars note that other areas of law respond to incentive problems by ameliorating the concerns rather than banning a practice entirely.[31] Finally, scholars argue attorneys' existing rules of professional conduct already prohibit frivolous litigation and actions conflicting with the client's best interest.[32]

Third-party finance is certainly not without its criticisms.[33] However, this phenomenon looks poised to take root in the United States. The remainder of this Note considers the best corporate form for a new litigation finance firm.

III. Potential Corporate Structures for Litigation Finance Companies

Once states adapt to this new litigation framework, firms will have to confront a new question: what is the optimal corporate form to operate a litigation finance firm? The ideal corporate choice balances factors such as access to capital; duties and obligations to capital contributors; conflicts of interest between capital sources, the firm, and claimants; information costs; and the firm's own liability.[34] Of course, states crafting finance-enabling legislation may answer that question for these firms, but this analysis assumes states simply negate laws prohibiting third-party litigation finance and allow new firms to

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26. *Id.*

27. *Id.*

28. Keith N. Hylton, *The Economics of Third-Party Financed Litigation*, 8 J.L. ECON. & POL'Y 701, 703 (2012). Hylton notes that, even if third-party funding increases the total volume of litigation, whether that increases or decreases social welfare depends on several—sometimes subjective—variables. *Id.* at 709–10.

29. Steinitz, *supra* note 14, at 1303.

30. Lorde Martin, *supra* note 10, at 83.

31. Steinitz, *supra* note 14, at 1325–26.

32. Lorde Martin, *supra* note 10, at 83.

33. *See generally* Joanna M. Shepherd, *Ideal Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL'Y 593 (2012) (discussing the drawbacks of third-party finance); Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649 (2005); Hall v. State, 655 A.2d 827 (Del. Super. Ct. 1994).

34. *See generally* Steinitz & Field, *supra* note 5 (discussing important factors for firms to consider when crafting ideal litigation finance contracts); Hylton, *supra* note 28 (examining the economic considerations faced by third-party litigation finance firms). For a general discussion of firm organizational choice and the underlying economics, see generally Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J.L. & ECON. 351 (1983) (addressing the relationship between legal organizational form and economic performance).

organize and operate like any other business.[35] This Note further assumes that the hypothetical firm requires capital from multiple sources, and also that the firm is organized under Delaware law.[36] I consider three corporate forms under Delaware law: a limited liability company, a traditional corporation, and finally a benefit corporation.

A. Factors Under Consideration

Before confronting the corporate forms themselves, it is helpful to identify the specific factors to balance in choosing the optimal corporate form. The competing interests in third-party finance come from three sources—the claimant and her lawyer, the funder, and the funder's shareholders.[37] Those competing incentives are explored below.

1. Claimants' Interests

The primary and most obvious concern in third-party finance is the funder's control—whether real or perceived—over the litigation itself.[38] Though some question the logic,[39] those opposed to litigation finance firms worry that claimants who rely on third-party funding will have no choice but to settle or continue litigation depending on the funder's desires.[40] Whether the concern is logically required, there is little controversy in the proposition that third-party finance should not supersede the claimant's control of her claim.[41]

To exemplify this concern, a plaintiff may bring a high-value claim but prefer a settlement in which the company discontinues the practice that led to his injuries. The funder, whose interest is almost certainly monetary, would lose on this transaction because there is no recovery for a mere promise. Another possibility could arise from a plaintiff with a high-value claim receiving an offer "too good to refuse," but where the funder takes on the litigation to pursue a favorable rule to set up future litigation opportunities.[42] Finally,

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35. For example, a state could require a third-party financier to organize as a partnership, a limited liability company, or some other mandatory corporate form.

36. Obviously the firm may be organized under the laws of any of the 50 states. Delaware was chosen solely for its ubiquity in the corporate law realm. However, states may compete for corporate organization, especially with new corporate forms being created in recent years. For an overview of that competition, see generally J. Haskell Murray, The Social Enterprise Law Market (2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2728099.

37. Again, this Note assumes the firm will require many sources to properly capitalize its operations.

38. *See, e.g.*, Steinitz & Field, *supra* note 5, at 724 (describing a typical third-party litigation funder as a firm set up and managed by attorneys); Michele DeStefano, *Nonlawyers Influence Lawyers: Too Many Cooks in the Kitchen or Stone Soup?*, 80 FORDHAM L. REV. 2791, 2794 (2012) (noting that nonlawyer clients can easily influence the independent legal judgment of lawyers).

39. *See* DeStefano, *supra* note 38, at 2794–96 (arguing protectionist strategies are counterproductive due to the way American lawyers actually practice and the global impact on the American practice of law); Saladini v. Righellis, 687 N.E.2d 1224, 1224 (Mass. 1997) (finding the agreement to advance funds for litigation "champertous and unenforceable").

40. DeStefano, *supra* note 38, at 2794–96.

41. On the other hand, some scholars call for the free alienability of claims—both before and after they have matured. *See, e.g.*, Molot, *supra* note 19, at 379 (arguing that many claims are not priced accurately, requiring the need for third-party funders); Charles Korsmo & Minor Meyers, Aggregation by Acquisition: Replacing Class Actions with a Market for Legal Claims (Oct. 1, 2014) (unpublished manuscript) (on file with the Iowa Law Review).

42. *See* Steinitz & Field, *supra* note 5, at 724 ("[T]he funder may have a strategic interest in the outcome of a case beyond winning the case at hand.").

scholars note that low-resource plaintiffs face the prospect of having to sacrifice substantial portions of a recovery in exchange for short-term, pre-judgment living expenses.[43]

2. Funder's Interests

A funder's interest in a litigation finance agreement will produce conflicts with both the claimants' and shareholders' interests. First, and most obviously, the funder's main goal is to maximize profit from its funded claims.[44] This will usually be accomplished through input from attorneys, economists, statisticians, and others seeking to maximize long-term return on investment (ROI).[45]

Additionally, as noted above, a funder will almost always prefer a monetary award or settlement unless there is a favorable rule at stake.[46] That reality brings up a third and important concern for litigation finance firms—avoiding the actual practice of law.[47] Firms need to take steps to avoid exercising such control over the claim that they appear to—or actually do—engage in the practice of law.

3. Shareholders' Interests

The final class of interest-conflicted parties is shareholders. Those who invest capital generally prefer to realize ROI sooner rather than later.[48] Consequently, shareholders' interest conflict with the funders' who would rather maximize return over time than maximize short-term ROI.[49] A corporate form will need to balance these competing interests and expectations. Furthermore, despite the corporate realm's separation of ownership and control, shareholders often look to exert some say in the company's direction. While this may conflict with the firm's interests, it could also encroach on the claimant's interests.[50]

Moreover, a critical conflict of interest that cannot be solved to the shareholders advantage without major legal ethics reform is the information asymmetry between claimant, claimant's attorneys, and the firm on the one hand, and the shareholders on the other.[51] Obviously, a funder cannot share privileged case information with shareholders.[52]

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43. Deborah R. Hensler, *Third-Party Financing of Class Action Litigation in the United States: Will the Sky Fall?*, 63 DEPAUL L. REV. 499, 501 (2014).

44. *See generally* Hylton, *supra* note 28 (discussing economic implications of third party litigation funding).

45. Some scholars, and many older judges, are skeptical of the role nonlawyers should play in litigation. For a critical view of that skepticism, see generally DeStefano, *supra* note 38.

46. Steinitz & Field, *supra* note 5, at 724.

47. *See* Steinitz, *supra* note 18, at 1169 (discussing legal constraints affecting litigation finance business models); *see also* MODEL RULES OF PROF'L CONDUCT r.5.5 (AM. BAR ASS'N 2002) (forbidding the practice of law by non-lawyers).

48. Timonthy A. Luehrman, *Investment Opportunities as Real Options: Getting Started on the Numbers*, HARV. BUS. REV. (1998), http://solvay.ulb.ac.be/cours/pirotte/INGESTcovalfi/readings%202014/2a%20-%20HBR%20Luehrman%20(1998)%20-%20%20Investment%20Opportunities%20as%20Real%20Options%20Getting%20Started%20on%20the%20Numbers%20(NW).pdf.

49. This obviously assumes mutual-exclusivity in maximizing ROI over different time horizons.

50. It is worth noting, that where there are conflicting incentives, the firm's interests will usually align with either the claimant's or the shareholders, but rarely both (though sometimes neither).

51. *See, e.g.*, Steinitz & Field, *supra* note 5, at 729–35. Though Steinitz discusses this in the claimant-funder context, the leap to the funder-shareholder context is not a large one.

52. *See* MODEL RULES OF PROF'L CONDUCT r.1.6 (AM. BAR ASS'N 2015) (explaining confidentiality of

Corporate form can ameliorate this concern to some degree, but shareholders cannot completely eliminate high information costs in this market.[53] To address these concerns, this Note analyzes three corporate forms to determine which is the best choice for a new litigation finance firm.

B. Limited Liability Company

1. Advantages

Limited liability companies (LLCs) are an increasingly popular choice for businesses.[54] Sometimes called "the best of both worlds," LLCs combine benefits of both partnerships and corporations.[55] Specifically, LLCs receive partnerships' advantageous tax treatment with corporations' limited liability.[56] Further, an LLC is not so restricted as a partnership—at least under Delaware law—as LLC "members" may both own and participate in an LLC's management and operations.[57]

In addition to the unique structural and tax advantages noted above, one of the major advantages an LLC could provide a litigation finance firm is the freedom to contract around default rules.[58] LLCs must file a certificate of formation and a separate "limited liability company agreement" at formation.[59] While the certificate sets out very basic company information,[60] the agreement allows LLC members to tailor the corporate structure in whatever manner they decide.[61] Because the Delaware LLC statute's policy is "to give the maximum effect to the principle of freedom of contract,"[62] an LLC formed in Delaware can contract around agency issues more inherent in traditional corporations.

That freedom of contract principle provides an additional, and perhaps overlooked, advantage. An LLC's agreement allows a firm to restrict or entirely eliminate fiduciary duties owed to other members and/or managers.[63] Whereas a typical corporation cannot contract away from fiduciary duties owed to shareholders,[64] LLCs may do so freely, and thus can more easily seek to maximize long-term profits at the expense of shareholder-demanded short-term ROI. Another benefit allows an LLC to contract around potential

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information rules).

53. Steinitz, *supra* note 6. Steinitz compares litigation funding to another high-information-cost market sector—venture capital.

54. *C-Corp, S-Corp, or LLC?*, DIRECT INCORPORATION, http://www.directincorporation.com/learn/c-corp_s-corp_or_llc (last visited Mar. 14, 2016).

55. 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 20.1 (1989).

56. *Id.*

57. *Id.* § 20.3.

58. *Id.* § 20.4.

59. *See* DEL. CODE tit. 6, § 18-201 (2015) (explaining the requirements of a certificate of formation).

60. The minimum information required in the certificate is the LLC's name, its address, and its registered agent's name and address. *Id.*

61. DEL. CODE tit. 6, § 18-1101(b) (2013); BALOTTI & FINKELSTEIN, *supra* note 55, § 20.4.

62. DEL. CODE tit. 6, § 18-1101(b).

63. *Id.* § 18-1101(c); BALOTTI & FINKELSTEIN, *supra* note 55, § 20.9.

64. Though a corporation can, through its certificate of incorporation, eliminate director liability for breaching certain fiduciary duties, DEL. CODE tit. 8, § 102(b)(7) (2015), the corporation cannot eliminate the *corporation's* duty to do the same. Courts generally construe a business's duty to create profit for shareholders as part of its duty of loyalty. BALOTTI & FINKELSTEIN, *supra* note 55, § 4.16.

direct conflicts of interest. The LLC's operating agreement could include a provision that all members warrant they have no actual or perceived conflicts of interest with ongoing litigation.[65]

Finally, LLCs are empowered to issue multiple classes of stock.[66] That ability allows an LLC to sufficiently capitalize its operation to finance claims—one of an LLC's marked advantages over a limited partnership. Most financed litigation will probably be low-risk, low-return, but firms will need capital if and when they seek a higher-risk, higher-return claim.

2. Disadvantages

There are fewer disadvantages for LLCs, but they do exist. First, and less critically, LLCs require careful and precise operating agreement drafting.[67] Additionally, LLCs are a concern for claimants because members tend to have substantial access to material firm information on the firm's business operations.[68] This feature stands in conflict with a litigation finance firm's need to keep information about the claim confidential.[69] While the LLC can use its operating agreement to bind all members to confidentiality, that becomes impractical at some point. And, at least traditionally, wealthy individuals, not stock issuance, capitalize LLCs.[70]

C. Traditional Corporation

A second option is a traditional, standard corporation. This Section analyzes the advantages and disadvantages of this corporate structure. Additionally, I briefly examine the additional option of taking a litigation finance corporation public. A corporation provides the classic form for any business looking to limit its own liability while raising large amounts of capital.[71] The corporation's structure is noted for its separation of ownership and control, a system that allows centralized decision-making and specialization to produce better outcomes than if all equity owners participated in decisions.[72] Further, several mechanisms of Delaware law insulate corporate directors from shareholder second-guessing—a feature or a vice, depending on your viewpoint.[73]

1. Advantages

The corporation's greatest advantage is its ability to raise capital. Delaware law, and

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65. This, of course, would need to be balanced with the need for claimants' confidentiality.

66. DEL. CODE tit. 6, § 18-302(a) (2014); BALOTTI & FINKELSTEIN, *supra* note 55, ch. 20.

67. BALOTTI & FINKELSTEIN , *supra* note 55, § 20.4.

68. DEL. CODE tit. 6, § 18-305 (2014). This is obviously a concern because most of the primary "information regarding the status of the business and [its] financial condition" is privileged.

69. Steinitz & Field, *supra* note 5, at 751–52; Steinitz, *supra* note 14, at 1299–1301.

70. Metro Comm'n Corp. BVI v. Adv. Mobilecomm Tech., Inc., 854 A.2d 121 (Del. Ch. 2004). Additionally, an LLC that issues stock will face even more problems relating to member access to privileged case information—especially if the member's ownership interest is alienable.

71. *See generally, e.g.*, BALOTTI & FINKELSTEIN, *supra* note 55 (discussing a corporation's freedom to contract).

72. *See generally* Eugene F. Fama & Michael C. Jenson, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (discussing the common structure and issues of corporations).

73. *See, e.g.*, BALOTTI & FINKELSTEIN, *supra* note 55, § 4.19 (explaining the business judgment rule).

market ingenuity, has developed several creative mechanisms for raising capital through both debt and equity instruments.[74] Corporations are expressly granted the power to issue multiple classes of stock.[75] While an LLC is technically able to issue shares through artful contracting, corporations' explicit grant is preferable. This explicit authority, combined with Delaware's well-developed law on the subject, make it easier for businesses to reliably issue stock and for investors to confidently purchase it.

Indeed, Delaware law is renowned for its expertise in corporate law. Risk-averse investors may prefer the security of a well-developed legal doctrine to enforce their rights. Additionally, investors—especially lay investors—are more likely to invest in a traditional corporation than a contract-dependent LLC arrangement.[76]

Corporations' capital availability is also more convenient for those wary of complex legal problems (and high transaction costs). Shares are freely alienable among corporate investors, compared to an LLC's complicated structure for assigning membership interests.[77] While none of this bears directly on the interests at play in a litigation finance firm, a more attractive investment is better for both shareholders and the firm. Moreover, similar to an LLC, a corporation can issue multiple classes of stock. This could further ameliorate agency problems, as most investors could be largely passive and retain very few control rights in the company.

The corporate decision-making structure is also advantageous for claimants and the litigation firm. The corporation's separation of ownership and control avoids several problems that are particularly dangerous for litigation finance. First, separation prevents capital owners from meddling in the firm's management.[78] Second, and related, corporations' decisions are better protected from second-guessing through the business judgment rule.[79] The business judgment rule is especially important due to the potential conflict between long-term and short-term ROI preferences for the funding firm and shareholders. Finally, corporations could use different stock classes to prohibit common stockholders from accessing business records.[80]

2. Disadvantages

The greatest disadvantage of a corporate structure is the conflicting duties of loyalty inherent in its structure. A litigation finance corporation will require a fierce duty to the claimant's interests, including her privacy, confidentiality, and the integrity of her ability

74. *See id.* § 5.1 (analyzing the distinctions occurring between debt and equity instruments).

75. *See* DEL. CODE tit. 8, § 151(a) (1953) ("Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof.").

76. *See generally* James C. Sargent, *The SEC and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553 (1974) (discussing what will return individual investors to the market).

77. *Compare* DEL. CODE tit. 8, § 151 (1953) (concerning various classes of stocks); BALOTTI & FINKELSTEIN, *supra* note 55, § 5.13 (concerning the nature of stocks), *with* DEL. CODE tit. 6, § 18-702 (2010) (explaining the assignment of limited liability interest); BALOTTI & FINKELSTEIN, *supra* note 55, § 20.4 (discussing the freedom to contract).

78. *See* DEL. CODE tit. 8, § 141(a) (2014) (concerning the board of director's powers).

79. BALOTTI & FINKELSTEIN, *supra* note 55, § 4.19 (referencing the business judgment rule as courts granting deference to businesses).

80. *See* Matulich v. Aegis Commc'ns Group, Inc., 942 A.2d 596, 599 (Del. 2008) ("Section 151(a) of the [Delaware General Corporation Law] affords Delaware corporations the ability to provide for the flexible financing that is necessary to meet the unique funding needs of the enterprise and the requirements of diverse investors in today's competitive global capital markets."); BALOTTI & FINKELSTEIN, *supra* note 55, § 5.3.

to prosecute her claim.[81] Some of this can be accomplished through the financing contract between the claimant and the funder.[82] However, the corporate fiduciary duty of loyalty requires "that a director not consider or represent interests other than the best interests of the corporation and its stockholders in making a business decision."[83] Working around this command could prove challenging, and will at least increase transaction costs in each financing venture.

Additionally, and similar to an LLC, Delaware requires corporations provide "[a]ny stockholder . . . the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from . . . [t]he corporation's . . . books and records."[84] While this right is subject to restrictions and limitations,[85] as noted above,[86] access to business records threatens the claimant's confidentiality and the integrity of the claim.[87]

3. Public vs. Private Corporations

Finally, it is worth considering the difference between a private and public corporation. While public corporations allow greater access to secondary markets,[88] they also entail much greater disclosure requirements. There are several potential problems with both structures. First, regarding private corporations, limited access to investors limits capital to some extent. Further, private corporations are more likely to rely on institutional investors whose interests are substantially more likely to straddle both sides of litigation.

On the other hand, while a public corporation would not be required to list ongoing contingent claims in its public disclosures,[89] public disclosure may be required for resolved claims. If the case severely limits claimants' and funders' options, they could not reasonably (or at least always) bargain for additional recovery in consideration for a non-disclosure agreement. Additionally, public disclosure of settlements would likely decrease a firm's future bargaining power, and thus resurrect agency concerns between the funder's long-term, repeat litigation and the claimant's once-in-a-lifetime experience with high-value litigation.

While corporations deliver several advantages, they come with several disadvantages in this particular field. Most troubling is the duty owed to corporate shareholders; a fierce duty to maximize their interests—profits—is a requirement in the traditional corporate model. Recently, however, a new brand of corporation has emerged and may offer an even

81. Steinitz & Field, *supra* note 5, at 735–37.

82. *See generally id.* (discussing and proposing contract provisions to abate conflicts of interest in litigation finance).

83. BALOTTI & FINKELSTEIN, *supra* note 55, § 4.16 (quoting Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986)).

84. DEL. CODE tit. 8, § 220(b)(1) (2010).

85. *See* Cent. Laborers Pension Fund v. News Corp., 45 A.3d 139, 143–47 (Del. 2012) (showing a situation where inspection rights were denied because the procedural requirements were not met).

86. *See supra* Section III.B.2 (describing disadvantages, including access to material information, of LLCs).

87. However, this Note acknowledges that different stock classes could prevent this problem by issuing common stock without inspection rights and preferred stock, reserving the latter for those who need to examine the privileged material.

88. For example, publicly traded companies can list on popular stock exchanges.

89. *See* Maya Steinitz, *How Much is that Lawsuit in the Window: Pricing Legal Claims*, 66 VAND. L. REV. 1889, 1918 (2013) ("Gain contingencies cannot be recognized on a company's income statement until all contingencies have been resolved.").

better fit for litigation finance firms.

D. Public Benefit Corporation

A public benefit corporation (B-Corp) is a "for-profit corporation . . . intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner."[90] The DGCL envisions that a B-Corp "shall be managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation."[91]

1. Advantages

A B-Corp combines the traditional corporation's capitalization advantages with an LLC's agency advantages. Whereas a traditional corporation requires directors to consider *only* the stockholders' best interests,[92] a B-Corp's directors are free to balance the stockholders' interests with those "materially affected" by the corporation's conduct.[93] Indeed, this requirement (or lack thereof) frees directors of the fiduciary rock and hard place of a traditional corporation. B-Corps also feature the traditional corporation's advantage of issuing multiple classes of stock. This can further solve the agency problem presented by traditional shareholder inspection rights, except there is a stronger policy argument on the B-Corp's side.[94]

Additionally, from a claimant's perspective, a B-Corp is advantageous because it incents the firm to take on low-resource plaintiffs. Unsurprisingly, one requirement of a public benefit corporation is to produce a public benefit.[95] While "public benefit" is defined very broadly,[96] scholars already call for third-party litigation finance to enable greater access to justice.[97] A recent article specifically called for litigation finance firms to organize as B-Corps to fund impact litigation.[98] A B-Corp focusing on commercial litigation would not necessarily need to take on indigent clients or impact litigation, but even commercial litigation could qualify as a "public benefit" as defined in the Delaware Code.[99]

90. DEL. CODE tit. 8, § 362(a) (2015).

91. *Id.*

92. It is worth noting that this requirement does not necessarily foreclose the corporation from acting in a manner consistent with the interests of *both* stockholders and claimants. However, it will likely require expensive litigation and creative arguments to align those groups' incentives.

93. DEL. CODE tit. 8, § 365(a) (2013).

94. This does not question a traditional corporation's ability to restrict access to corporate records through preferential or common stock.

95. DEL. CODE tit. 8, § 362(a) (2015).

96. *See id.* § 362(b) (defining public benefit).

97. *See, e.g.*, Steinitz, *supra* note 6, at 517 ("VC contract theory, practice, and doctrine can guide plaintiffs, lawyers, financiers, and courts on what can be done, what should be done, and how to do it."); Steinitz, *supra* note 89, at 1924 (calling the result of these funding contracts an "increased access to justice").

98. *See* Jason M. Wilson, *Litigation Finance in the Public Interest*, 64 AM. U. L. REV. 385, 391 (2014) ("[P]roposing a social enterprise model whereby a litigation financing firm organizes as a public benefit corporation under Delaware law with the purpose of funding public interest cases.").

99. DEL. CODE tit. 8, § 362(b).

2. *Disadvantages*

The biggest disadvantage to a B-Corp is also inherent to traditional corporations—taxes. While LLCs are taxed on the share of profits received by owners, B-Corp shareholders are essentially "double-taxed": once when revenue comes into the corporation, and again when that revenue is distributed to shareholders.[100] Even at preferable capital gains rates, the difference in post-tax income for shareholders may be significant enough to affect some marginal decisionmaking. Finally, and a concern B-Corps share with traditional corporations, there are few restrictions on who can invest in B-Corps, meaning an adverse party to the firm's litigation can potentially create a conflict of interest by purchasing shares of the firm. Firms can overcome this last issue by requiring stock purchasers warrant they have no interest in the firm's litigation, possibly stipulating the pled value of the suit as damages for breach of that warranty.

While this analysis is not, and does not claim to be, an exhaustive inquiry into the optimum corporate form for any specific litigation finance firm, it paints the broader picture and compares the most relevant and most likely candidates under which these firms can and will organize.

IV. CHOOSING THE RIGHT CORPORATE FORM

The question remains: which type of corporate structure is best for a litigation finance firm? Given the agency difficulties, the unfavorable tax treatment, and the inherently conflicting loyalty at the firm director-level, a traditional corporation is not the best fit. The corporation's greatest advantages are the relative ease of raising capital and the separation of ownership and control. However, B-Corps offer those same advantages with fewer fiduciary problems.[101] LLCs provide more favorable tax treatment and more flexibility.[102] Rather than a convenient middle ground, a traditional corporation is the worst of both worlds and should be avoided as a model for litigation finance firms.

The other two options—an LLC and a B-Corp—are each reasonable choices. Indeed, using an LLC for potentially high-risk, high-transaction-cost firms is not merely the whim of this author. Several prominent venture capital funds are organized under the LLC framework as well.[103] Scholars note the similarity and compatibility of the venture capital business model with third-party litigation finance.[104] Similarly, while B-Corps simply have not existed for long enough to have significant traction in the business world, many companies are recognizing its advantages, both in structure and public relations.

This Note concludes that both an LLC and a B-Corp are adequate corporate forms, though they are each appropriate in different settings. First, an LLC is the best form when the litigation finance firm will consist of a small group of wealthy members. Capitalizing from a small pool is not uncommon. In fact, most venture capital funds are organized as

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100. BALOTTI & FINKELSTEIN, *supra* note 55.

101. DEL. CODE tit. 8, § 362.

102. *See supra* notes 55–61 (discussing Delaware's LLC policies).

103. *See, e.g.*, WINKELVOSS CAPITAL LLC, https://winklevosscapital.com/about/ (last visited Mar. 14, 2016); ANDREESON HOROWITZ, http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=60273327 (last visited Mar. 14, 2016); KHOLSA VENTURES LLC, http://www.bloomberg.com/profiles/companies/3388266Z:US-khosla-ventures-llc (last visited Mar. 14, 2016) (discussing LLC and B-Corp structures).

104. Steinitz, *supra* note 6.

LLCs and capitalized by a small number of high-wealth investors.[105] The LLC form is ideal in this setting because the magnitude of each member's investment shifts his or her incentives. With so much capital at stake, each member has a greater say in the firm's management, perhaps even in which cases they take on. On the other hand, members' larger investments are likely to exacerbate the firm's incentive to pressure claimants into taking monetary rather than injunctive relief.[106]

Moreover, these high-wealth investors will be less likely to divulge the confidential information involved in each case. If an opposing party in litigation receives privileged information, the claimant's position is weakened and, by extension, the firm risks a smaller return on that claim. Thus, each member's substantial investment is aligned with the claimant's in most regards. Finally, the flexibility that attends the LLC form will give litigation finance firms capitalized by a few wealthy members the opportunity to tailor the business to their exact needs. While this will likely increase transaction costs, that increase is relatively small when dealing with only a small group of investors rather than thousands of stockholders.[107]

Conversely, if the firm anticipates capitalizing more broadly, a B-Corp is the better option. A B-Corp retains many of the traditional corporation's advantages over an LLC.[108] Critically, the B-Corp allows the board of directors to subordinate stockholder profit in favor of its "public benefit" and is shielded from stockholder second-guessing by the powerful business judgment rule.[109] The business judgment rule is crucial to a diversely capitalized litigation finance firm's success.

In addition to avoiding investor intervention in the firm's management, the B-Corp structure allows a firm to amass substantial capital while avoiding information disclosures to each capital source.[110] While a B-Corp is required to allow shareholders certain inspection rights,[111] the stockholder has the burden to prove he or she has a "proper purpose" for inspection, a fairly difficult burden to meet.[112] These protections allow firms to prevent disclosing confidential claim information while still providing access to capital.

V. CONCLUSION

This Note provides a framework for litigation finance firms looking to incorporate in the United States. While an LLC and a B-Corp offer different advantages for different circumstances, both forms serve the critical function of attenuating firms from the agency problems created by the competing interests of claimants and funders and deliver substantial benefits to the firm itself.

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105. *See supra* note 102 (discussing Delaware LLC law).

106. As noted, this conflict is ameliorated through corporate structure and contracting. *Supra* text accompanying notes 78–80.

107. *See supra* text accompanying note 76 (noting that lay investors are more likely in invest in traditional corporations).

108. *See supra* Section III.C.1 (highlighting the advantages of traditional corporations).

109. DEL. CODE tit. 8, § 365(a) (2015); *see also* Cent. Laborers Pension Fund v. News Corp., 45 A.3d 139, 143–47 (Del. 2012) (holding that a pension fund failed to provide proper documentation that it was a beneficial owner of stock in a company).

110. *See supra* note 68 (discussing access to sensitive firm information).

111. DEL. CODE tit. 8, § 220(b).

112. Seinfeld v. Verizon Commc'ns, Inc., 909 A.2d 117, 119–25 (Del. 2006).