

Third-party litigation funding in financially distressed situations

Olomon Ljumani introduces the topic of litigation finance and examines it from a practical perspective for insolvency practitioners



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In insolvency proceedings, the debtor is confronted with potential legal proceedings far more often than usual. Clawback claims are asserted in court, rights of separation are disputed, and former managers are often held liable for wrongful or even fraudulent trading.

By their very nature, insolvency proceedings mean that debtors regularly lack sufficient financial resources to pursue even the most promising legal actions. This raises the recurring question of how litigation aimed at augmenting the insolvency estate can be financed. Legal aid from the state, where available, is always subject to conditions and is usually granted on a limited basis,¹ making it especially

unsuitable for large-scale cases. In addition to the possibility of obtaining necessary funds from creditors, financing through a litigation funder has become an increasingly popular option in recent years, both globally² and across Europe.³

The concept of third-party litigation funding

The basic concept of third-party litigation funding is relatively straightforward: a litigation funder agrees to cover the legal costs incurred in pursuing a claim in exchange for a share of the proceeds from any successful legal action. In essence, the funder advances the claimant's lawyer fees, court fees, and, where necessary, the costs of expert witnesses. If the claim succeeds, the funder is reimbursed for these

expenses and receives a pre-agreed share of the recovered amount. This arrangement means that the funder assumes the entire financial risk of the litigation on behalf of the claimant.

Naturally, there are many variations of this model, depending on the specifics of the case. For instance, it's not unusual for a funding agreement to exclude the opponent's legal costs entirely or to cap the amount covered. The litigation funding market continues to evolve, offering a range of financing options beyond traditional models. In some cases, funders are getting involved at an earlier stage, financing the investigation and assessment of potential claims. Alternatively, there is also the option of monetising the claim in its entirety in order to provide the

debtor with liquidity as quickly as possible.

Third-party litigation funding in insolvency proceedings

As mentioned above, during insolvency proceedings, the debtor or insolvency administrator typically faces the challenge of funding legal actions that could potentially increase the insolvency estate yet whose costs exceed the available financial resources. Besides third-party litigation funding, there is, of course, the option of having the respective litigation financed by creditors. However, creditors are generally reluctant to bear litigation costs, particularly due to the inherent uncertainties associated with court proceedings. Creditors who have already been forced to accept significant reductions in their claims are often afraid of “throwing good money after bad”.

Third-party litigation funding presents an alternative, and it is becoming increasingly common for companies in financial distress or insolvency administrators to engage a litigation funder to enable the pursuit of claims for the benefit of the insolvency estate.

Even if the debtor’s own financial resources are theoretically sufficient to fund the litigation, it may still be advantageous to shift the costs to a litigation funder. This allows the funds of the debtor or estate funds to remain available for other essential aspects of the insolvency proceeding. This is particularly relevant when the debtor’s business operations are being continued. In such cases, management or the insolvency administrator must assess whether the available financial resources would be better spent on purchasing work materials, retaining staff, or maintaining production, rather than committing them to litigation. In some situations, the benefit of additional revenue from ongoing operations may outweigh the disadvantage of having to share litigation proceeds with a funder.

This is especially true given that litigation is essentially an investment in the future, whereas revenue from ongoing business activities is more likely to materialise in the short term.

Another important strategic consideration is the potential to apply pressure on the defendant. Although litigation funding generally does not have to be disclosed to the opposing party, it can be – and doing so may offer two key tactical advantages. First, it signals to the defendant that the claimant has sufficient financial backing to pursue the case through to its conclusion. Thus, even if the claimant is in financial distress, the defendant cannot rely on the prospect that the case will be dropped due to a lack of funds. Second, the involvement of a professional litigation funder – whose business it is to evaluate the merits and risks of legal claims – suggests that the case is considered strong. Both factors can significantly influence settlement negotiations in the claimant’s favour.

Another available option is so-called “cross-financing”. This is particularly relevant in insolvency proceedings where the debtor or insolvency administrator is pursuing multiple similar claims – for example, clawback actions against various parties. In such cases, the debtor may enter into an agreement with a litigation funder to finance these claims as a bundled package. Under this arrangement, the funder and debtor agree that proceeds from successful lawsuits can be used to offset the costs of those that are unsuccessful. This model can be an effective tool for insolvency administrators, as it may incentivise the litigation funder to take on cases that by themselves might appear less promising. By spreading financial risk across a portfolio of claims, both parties benefit from greater flexibility and potentially higher overall returns for the insolvency estate.

All these factors must be carefully considered and weighed by the insolvency administrator or the debtor’s management, acting in their fiduciary capacity, when

deciding whether to engage a litigation funder. Depending on the value of the claim and the jurisdiction, prior approval from creditors may be required. In Germany, for example, such approval is necessary when a “significant amount is in dispute” – a threshold that must be assessed on a case-by-case basis for each court proceeding. However, even where creditor consultation is not legally mandated, it is generally advisable in cases involving substantial amounts, as insolvency administrators invariably depend on creditor cooperation across all legal systems.

Third-party litigation funding is currently experiencing significant growth, with an increasing volume of cases being financed, both generally and specifically in the context of insolvency proceedings and financially distressed companies. As this trend continues, further development of the market and expansion of funding services tailored to companies in financial crisis can be expected. Alongside the rise of litigation funding, particularly at the EU level, there have been growing calls for regulation of the industry. Recent studies on the subject, intended to serve as a basis and aid for possible legislation by the European Union, argue in favour of a moderate regulation.⁴ ■

Footnote:

- 1 For an overview of legal aid regulations in the largest European countries, see: Maurits Barendrecht et al., *Legal Aid in Europe* (HilL Report, 1 February 2014), available at: www.hill.org/research/legal-aid-in-europe/
- 2 Research and Markets, *Global Litigation Funding Investment Market Trends and Forecasts, 2018–2023 and 2023–2028* (25 April 2024), available at: www.globenewswire.com/en/news-release/2024/04/25/2869793/28124/en/Global-Litigation-Funding-Investment-Market-Trends-and-Forecasts-2018-2023-and-2023-2028-Rise-of-Non-Recourse-Financing-Increased-Transparency-and-Regulation-Diverse-Funding-Source.html
- 3 European Parliamentary Research Service, *Responsible private funding of litigation, European added value assessment* (March 2021), 3.
- 4 Study on Mapping Third Party Litigation Funding in the European Union (request for services JUST/2023/PR/JCOO/CIVI/0016) in the context of the framework contract n° JUST/2020/PR/03/0001, p. 15



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