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Radulović, Branko. 2020. *Ekonomska analiza korporativnog stečajnog prava (The Economic Analysis of Corporate Bankruptcy Law)*. Beograd: Pravni fakultet Univerziteta u Beogradu, 217.

The importance of an adequate [corporate bankruptcy law] and its reliable enforcement [...] is perhaps best appreciated when it is missing.[1]

A common, rather naïve view of bankruptcy law is that it boils down to a set of legal procedures that serve to facilitate the undesired yet inevitable scenario of a firm's demise. It is unsurprising that, outside the legal or economic profession, people usually hope to never have to become acquainted with its scope and consequences. The optimism bias inherent in almost any entrepreneurial endeavor is likely to undermine managers' effort to get to know bankruptcy rules at the time of issuance of debt. It is at the later stage, often at the time of financial or economic distress when the "nitty gritty" details start to matter a great deal. Is it worth making an extra effort to make the project succeed? Does it pay to hide unfavorable information from creditors? Would opting for a riskier investment reduce the chances of being left emptyhanded? Is it better to file for bankruptcy today or tomorrow?

Creditors, in contrast, are likely to price in the uncertainty surrounding collecting their claims well before any contingency appears on the horizon. Weak protection of creditors' rights in times of financial difficulties can lead to credit tightening ex ante, with far-reaching consequences for the economy. Once a credit is extended, so long as bankruptcy rules affect the debtor's incentives, the creditors adapt. They have to decide how much

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[1] These words are borrowed from Modigliani, Perotti (1997, 520), which use them to describe the importance of a regulatory framework for the development of financial markets. The same seems to hold true for bankruptcy law.

effort to put into monitoring the debtor's activities, aimed at minimizing the risk of project failure. As it becomes evident that collection of their claims is impaired, creditors also must make decisions on several important issues, including whether to provide additional financing or whether to give up a portion of their proceeds to enable the financial rescue of the debtor. Diverging interests between different classes of creditors is yet another concern that bankruptcy rules may sometimes attenuate.

The latest book by Branko Radulović sheds light on these important matters by describing different trade-offs created by rules that are more favorable to creditors or debtors. Focusing mainly on the rules in the US, which have influenced bankruptcy regimes worldwide, the author provides perhaps the very first systematic account of the economic analysis of corporate bankruptcy law. He critically examines state-of-the-art theoretical and empirical scholarship to reassess the merits of different procedures for resolving financial distress. The reader of the book is likely to be particularly drawn into the issue of how the optimal bankruptcy framework depends on a wider legal and economic context, which the author uses to conclude his investigation of the topic.

One should not feel overwhelmed by the number of questions announced at the very beginning of this review, as the author makes smooth transitions from introductory chapters and basic intuition to more technical formal models. At the very beginning, the author explains the three core functions of bankruptcy law: 1) preserving the value of the debtor 2) deciding on the use of debtor's assets 3) deciding on how to distribute the proceeds. The second role is particularly important, as the choice between liquidation and reorganization has to ensure that debtors in financial distress, i.e. those with positive net present value, continue to operate, while those in economic distress are dissolved, so the assets can be more efficiently utilized for alternative uses.

One can ask why bankruptcy rules are fundamental for achieving these roles; after all, in well-functioning market economies, creditors can always attempt to collect their claims individually. To this end, the author explains the most important normative theories on why bankruptcy law matters. The most influential theory up to date has been the Creditors' Bargain theory. According to this theory, bankruptcy procedure serves to solve the collective action problem among creditors who otherwise have incentives to inefficiently liquidate the debtor in the race to collect their claims. The debtor's assets may be seen as a common pool problem, which not only leads to substantial strategic costs of being the first in line but may also decrease the total value of the debtor. Therefore, bankruptcy law serves to ensure the outcome that the creditors would have agreed on among themselves, had

they been able to negotiate ex ante, at the time of debt issuance. To use game theory jargon, bankruptcy law prevents the inefficient Nash equilibrium. Creditors' bargain theory has been modified several times. The aim is to revisit the original view that bankruptcy law should ensure that rules on settlement priority during the bankruptcy proceedings do not deviate from the applicable rules before such proceedings are initiated. The rationale for certain deviations may lie in risk-sharing scheme among creditors, ensuring that the debtor does not have incentives to take too much risk or to delay the bankruptcy proceedings, protection of idiosyncratic investments, protection of third parties' interests, or solving liquidity issues due to debt overhang. A somewhat different approach is taken in Casey (2020), emphasizing that bankruptcy rules are there to enable real ex post renegotiations, instead of simulating hypothetical ex ante negotiations among creditors. The reason is that ex ante contracts are inherently incomplete, given the number of creditors and possible contingencies. The bankruptcy proceedings allow creditors to fill the contract loopholes ex post with the help of a judge. In contrast to Creditors' Bargain theory, the contract theory approach to bankruptcy emphasizes that bankruptcy rules should not be mandatory, as coordination failure among creditors is not that common, allowing them to conclude ex ante contracts. Bankruptcy rules should instead serve to facilitate bargaining between creditors and the debtor. The author also critically examines a number of competing (traditional) normative theories, which believe that the bankruptcy law should serve a much wider set of goals. The author concludes this chapter by presenting two contrasting economic models that examine the merits of bankruptcy law as a mandatory regime for resolving financial distress, which are very much in line with conjectures of Creditors' Bargain theory and the contract theory approach to bankruptcy.

Bankruptcy regimes worldwide differ substantially with regards to some of their core concepts. One of the most debated questions in the literature is whether and when it is desirable to deviate from the absolute priority rule of settlement, i.e. to allow for a redistribution of proceeds from senior creditors to junior creditors and/or the debtor. Such a deviation is common in reorganizations. The rationale behind it is that it provides incentives for the debtor to reveal information and timely initiate bankruptcy, which otherwise threatens to impair the value of the company and create additional procedural costs. Moreover, it also disincentivizes the debtor to make an unrealistic estimation of the company's value, which may eventually dilute the share of creditors' claims in the company's proceeds. While these considerations are important, so are the changes in the ex ante incentives for both creditors and the debtor, as the author explains through a series of formal models. The effect of deviation from the absolute priority rule on ex

ante incentives is not unambiguous. The debtor may prefer to choose riskier projects, as they can appropriate some of the company's value even in case of a failure. This in turn incentivizes creditors to ask for a higher interest rate, which further aggravates the problem of adverse selection. However, the debtor's preference for riskier investments may reverse if the debtor is already facing financial distress, as one of the models shows. Moreover, redistribution of proceeds in the bankruptcy procedure may motivate the investor to make idiosyncratic investments, such as investments in human capital specific to the company or the project. Finally, deviation from the absolute priority rule makes creditors more alert about debtor's activities, thus increasing their monitoring efforts. As the author explains, the tension between ex ante and ex post incentives created by the absolute priority rule and its deviations shows all the delicacy of designing the optimal bankruptcy regime.

The author devotes much attention to the choice between mechanisms (procedures) for resolving financial distress: liquidation, reorganization, as well as out-of-court restructuring and hybrid mechanisms. The aim is to maximize the value of the debtor while minimizing the direct and indirect costs, including reputational costs for the debtor. Informal procedures (workout or out-of-court restructuring) are usually attempted first as cost-efficient and flexible alternatives, but they are difficult to implement when information asymmetry or the hold-out problem is pronounced. The latter refers to the situation in which certain creditors behave opportunistically to extract a larger share in the distribution of proceeds, which is common if there is a large number of investors. Hybrid mechanisms can attenuate some of these concerns, as the involvement of the court allows to impose the pre-packaged reorganization plan on dissenting creditors. Nevertheless, liquidation and reorganization continue to be the most commonly used procedures, and the greatest challenge in choosing between them lies in the efficient differentiation between efficient and inefficient debtors. Liquidation has the advantage of being fast and cheap, without redistributing value between different classes of investors and the debtor. However, the biggest disadvantage lies in the danger of decreasing the value of the debtor due to the high costs of information gathering for potential buyers. Reorganization suffers from a different set of weaknesses. In addition to being administratively complex, it allows debtors to behave opportunistically as decisions about the use and the distribution of assets are closely intertwined. Moreover, the evaluation of the debtor's value is done by the courts, which are often neither equipped nor incentivized to do it properly. The last part of this chapter is the most thought-provoking, as the author examines alternative ways of estimating the value of the debtor. The idea is to allow for a market-based valuation of the company while avoiding conflicts over

the redistribution of proceeds, inherent in a joint decision over the use and distribution of assets. The first alternative is an auction of a small portion of a company's shares (10%), which is done after all the debt is converted into equity. The author emphasizes that this process is nevertheless imperfect, not only because it is only applicable to listed companies, but also because the estimation may not be correct in a situation in which the buyer in the auction does not get control over the company. The second alternative implies the use of options. The proposed solution entails several steps. First, the claims of senior creditors are converted into equity, so they become the sole proprietors of the company. All the junior creditors and the shareholders of the debtor are given stock options to buy shares from senior creditors at a pre-determined price. Depending on their estimation of the value of the company, they can use their stock options, which would compensate senior creditors in the amount corresponding to their former claims, while junior creditors or the shareholders would appropriate the remaining value of the company. The convenience of this alternative is that it allows the absolute priority rule of settlement to be followed, without the need to determine the company's value beforehand. Some modifications of this solution also entail the involvement of the court. The author also presents other alternatives discussed in the literature, which are aligned with previously mentioned contract theory approach to bankruptcy.

The following chapter of the book is dedicated to the empirical research in the field of corporate bankruptcy. Before diving into a comprehensive overview of the most influential empirical findings up to date, the author explains in detail the key methodological considerations and challenges of empirical investigations in the field. These include sample selection bias, availability and reliability of data, appropriateness of most widely used indicators, and most importantly, the issue of self-selection bias. Namely, the decision to file for bankruptcy, as well as the choice of mechanism for resolving financial distress (e.g., liquidation or reorganization) is endogenous, i.e. it depends on the debtor's often unobserved characteristics, which may be correlated with the outcome of interest. The author also discusses potential solutions for each of these concerns, and then summarizes the findings of the empirical literature according to topic. Three topics have received the most attention in the literature: the size and determinants of costs of bankruptcy, determinants of procedure selection, and the determinants and effects of deviations from the absolute priority rule. Another strand of fast-growing literature focuses on the role of judges and determinants of biases in their decision-making.

The ultimate goal of the economic analysis of corporate bankruptcy law is providing guidance on the optimal design of rules. In line with the theoretical considerations above, as well as the diversity of empirical findings, it becomes evident that one size does not fit all. Moreover, the choice of bankruptcy provisions and diversity in national bankruptcy frameworks is in itself a very interesting research topic, which the author examines at the beginning of this chapter. One of the most heated debates has been what determines whether the framework is more debtor-friendly or creditor-friendly. One explanation offered in the literature is that a predominant corporate government mechanism may play a decisive role. Countries in which concentrated ownership is common, such as Germany and Japan, have primarily developed ex ante mechanisms of corporate governance, and consequently, have a preference for liquidation, or a creditor-friendly bankruptcy regime. This stands in contrast to countries with dispersed ownership structures, such as the US, in which ex post mechanisms of corporate control through takeovers have become predominant, and therefore, created the need for a more debtor-friendly bankruptcy regime. Another factor that received much attention in the literature is legal origin. The second part of this chapter examines how the optimal design of bankruptcy regime changes with the ability of judges to make proper estimates of a net present value of the debtor, as well as the degree of asymmetry of information between creditors and the debtor. In sum, liquidation may be more preferred in jurisdictions with higher quality judicial systems, and where banks are dominant creditors and can effectively monitor debtor's activities. In contrast, for countries with dispersed ownership and developed financial markets, as well as undeveloped countries with concentrated ownership, it is optimal to have both procedures (liquidation and reorganization).

The very rich account of the most important discussions on the topic of corporate bankruptcy, provided in this book, can be helpful to different audiences. Firstly, the book is intended for law and economic scholars interested in exploring research avenues in the field of corporate bankruptcy law either from a theoretical or an empirical perspective. The research gap seems particularly pronounced with regards to indirect costs of different bankruptcy procedures, the merits of alternative (market-based) solutions to financial distress, and other bankruptcy provisions not directly linked to the absolute priority rule and its deviations. The fact that most of the contributions in the field examine rules in developed economies, primarily in the US, offers a wide array of possibilities for scholars to explore jurisdictional divergences, including, as the author points out, the importance of culture and informal institutions for the choice and efficiency of different bankruptcy rules and procedures. Secondly, this book can be very useful to economists and lawyers specializing in this area. It will allow

them to fully grasp the economic tradeoffs behind certain legal solutions, as well as the consequences of deliberate choices made during the bankruptcy proceedings. Finally, the book may serve as a good starting point for considerations on how to reform an existing bankruptcy framework, taking into account the author's meticulous explanations of key factors for a well-tailored regime.

In the end, one may only wish that Radulović will continue to enrich this book as the scholarship in this important field continues to expand, with many more successful editions to come.

REFERENCES

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