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TRABAJO FIN DE GRADO EN
ADE DEL PROGRAMA INTERNACIONAL DEL DOBLE GRADO EN DERECHO Y
ADMINISTRACIÓN DE EMPRESAS

SPECIAL DIVIDENDS AND PRIVATE EQUITY. AN APPROXIMATION TO THE
SPANISH CASE.

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ABSTRACT

The development of the Private Equity industry is one of the recent phenomena that have altered the current economy of corporations. This new business model has some positive connotations for the capitalistic economy, but the drawbacks that Private Equity implies for society might be much bigger than its advantages. One of these drawbacks is the distribution of special dividends to the Private Equity funds.

The aim of this project is to analyse the negative consequences that the distribution of special dividends implies for the companies acquired in the Private Equity business. To do so, this project focuses on how the necessary cash is obtained and how the distribution of such cash eats up the equity's safety cushion in which it is based. These two circumstances entail negative consequences for the target companies, as they lose operational effectiveness and their viability in the long term is seriously questioned. The analysis of these consequences, especially focused on the Spanish case, is the main objective of this project.

Key words: Private Equity, special dividends, dividend recapitalization, General Partners.

RESUMEN

El desarrollo de las Sociedades de Capital Riesgo es uno de los fenómenos más recientes que ha alterado la economía de mercado actual. Este modelo de negocio tiene una serie de aspectos positivos propios de la economía capitalista, pero los problemas que causa a la sociedad podrían ser más grandes que sus ventajas. Uno de los principales problemas de estas sociedades es la distribución de dividendos especiales.

El objetivo de este trabajo es analizar las consecuencias negativas que conlleva la distribución de dividendos especiales dentro de las Sociedades de Capital Riesgo. Para ello, este trabajo está centrado en analizar tanto formas de obtener el capital necesario como las formas de distribuir ese capital, reduciendo drásticamente el colchón patrimonial de la empresa. Las consecuencias de estas dos actividades son negativas para las empresas, ya que pierden capacidad operativa y su viabilidad a largo plazo se ve seriamente cuestionada. El análisis de estas consecuencias, especialmente centrándose en el caso español, es el principal objetivo de este trabajo.

Palabras clave: Sociedades de Capital Riesgo, dividendos especiales, recapitalización de dividendos, Socios Generales

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1. INTRODUCTION

The present document is my final project for the International Double Bachelor's degree in Management, Business Administration and Law in the Public University of Navarre (UPNA). This project is going to treat the conflictive issue of the special dividends paid out to General Partners in the Private Equity market, emphasizing in the Spanish case.

I have decided to carry out this project because I have always been interested in companies that go bankrupt and also in how these situations can be analysed from a theoretical and empirical point of view. Therefore, I am very interested in analysing Private Equity firms and their *carte-blanche* to pay special dividends to their General Partners. This practice might be correlated with the high percentage of companies that go bankrupt after being managed by Private Equity firms.

The first section of this project consists of discussing both the positive and the negative connotations of Private Equity. In this sense, I explain how the Private Equity business is expected to operate according to the theoretical concept recorded in academical books. On the other hand, I present how different the reality might be from this theoretical point of view.

The second section is focused on the special dividends that General Partners distribute among themselves in the Private Equity business, which in fact is the core of this project. This section starts by introducing the concept of both ordinary and special dividends. Then, and more concretely, I present the problem of special dividends in the Private Equity business, describing the negative effects that they have in the companies acquired by a Private Equity fund. This part of the project is focused on analysing the sources of obtaining the necessary cash (dividend recapitalizations and asset stripping) as well as the sources of distributing such cash (equity's safety cushion). I also illustrate this section with some famous cases of companies acquired by Private Equity firms in which exorbitant dividends were distributed along the years. This section ends up with an exhaustive analysis of the legal regulations – either company law or Private Equity specific law – that exist in the United States, the European Union and Spain that have been approved in order to protect companies against the distribution of special dividends, as well as a personal opinion about how effective they are.

The third section of the project presents an empirical research carried out with a sample of 106 PE-backed Spanish companies that have been subjected to a Leveraged Buy-Out between 1996 and 2011. The empirical research starts with a descriptive analysis that gives clear evidence that the distribution of special dividends is more common than what it seems, and that it creates serious financial problems to the companies acquired by a Private Equity fund. These results suggest that, in order to protect companies against the distribution of special dividends in the Private Equity industry, a more restrictive legislation might be more than necessary. I finally illustrate a logistic regression model where I want to test the relationship between the distribution of special dividends and bankruptcy. I have found that special dividends only have a significant impact on triggering bankruptcy when the companies are in a relatively stable and well-balanced situation. In fact, besides the distribution of special dividends, the main problem of Private Equity might rely on the intrinsic practices developed within this industry.

Finally, the project ends up with some conclusions obtained from both the theoretical and empirical sections. I hope that these conclusions would be useful to better understand the dark side of the Private Equity business and the negative connotations that distributing special dividends imply, which may have some political and regulatory implications in order to restrict this drawback of the Private Equity business model.

2. THE CONCEPT OF PRIVATE EQUITY

2.1. The positive (theoretical) vision of Private Equity

There are plenty of definitions of private equity (or the acronym, PE). According to Aon Insurance (2019), *“private equity is an investment that involves a purchase of part, or all, of a company that is not listed on a public stock exchange. The investment is used to enhance value and improve performance before being sold for a significant profit”*. This one may be the most theoretical and simplest definition of PE, but it is enough to understand the concept and be ready to go deep into the positive vision of the issue.

This positive point of view is the one defended by the PE industry and by the people with interests in these kinds of businesses. Following this point of view, *“private equity in many scenarios can be a win-win for both the founder and the management team, enabling the business to grow with the support of experienced investors and generating significant financial uplift for all shareholders on the ultimate exit”*

(Cummins, 2017). This vision of PE is not only defended by people with interests in the business, but it is also explained in universities and conferences as an example of profitable investments and extraordinary management (Eaton et al, 2019).

The theoretically ideal functioning of a PE firm is the following. A Private Equity fund is created through the substantial contribution of Limited Partners (from now on, LPs), which are different investors - public pension firms, insurance companies - that want to obtain profitability from their investment; and through the small contribution of General Partners (from now on, GPs), which are known as the PE firms. In fact, and although LPs contribute with almost the 99% of the equity for the PE fund (Appelbaum & Batt, 2014), the GPs are the ones who run the PE fund and make the key decisions. Once the PE fund is constituted, the GPs look for a target company to be acquired. Usually, they look for private companies with multiple avenues of growth, so that the company's success is not dependant on only one value driver (Street of Walls, 2013). Normally, the acquisition process is carried out through a Leveraged Buy-Out (from now on, LBO), a special mechanism by which a company is purchased using a significant amount of borrowed funds.

An LBO usually starts with the creation of a Newco, a new company created from the cash accumulated in the PE fund (in fact, this is an artificial company that only has cash, not any other asset). Afterwards, and this is the crucial step in an LBO, the Newco asks for a significant amount of debt in order to finance the takeover of the target company. At that moment, the social capital of the Newco is formed, approximately, by 30% of equity and 70% of borrowed debt (Appelbaum & Batt, 2014). With all the cash obtained from the PE fund, but specially from the borrowed debt, the Newco carries out the acquisition of the target company. Then, the most common situation is that Newco merges with Target, creating a new company that from now on it will be called "portfolio company". Here, it is necessary to understand that all the liabilities assumed by the Newco are now liabilities of the portfolio company too. Once the merger has been completed, a new managerial group assumes the management of the portfolio company and their goal is to increase the value of the firm through the optimisation of all the available resources. When the company has increased its value considerably thanks to a "magnificent" management, the GPs decide to sell it. The average holding period of a PE investment is four years (Phalippou, 2017). Finally, after the sale is concluded, both the LPs and the GPs obtain the pertinent remunerations from their investment.

2.2. The negative (real) vision of Private Equity

The aforementioned positive vision of Private Equity is not always in agreement with what we can see in the reality. Probably, the main problem comes from the intrinsic meaning of the Leveraged Buy-Out itself, as the majority of the money used to afford the takeover comes from borrowed funds, making the portfolio company - not the PE fund - the only responsible for repaying the debt. In this sense, the portfolio company suffers from a huge increase in its financial risk since the very beginning, as it has the burden of repaying the liabilities previously assumed by the Newco. To make things worse, PE firms tend to overpay when they are purchasing target companies (Froud & Williams, 2007), forcing the portfolio company to recognize a considerable goodwill in its balance sheet. This assumption can be empirically strengthened by the evolution of multiples, as in 2021 Private Equity deal activity has achieved a record valuation level of 10.7x EV/EBITDA in the EU and 14.7x EV/EBITDA in the US (Mondesir & York, 2021). Despite being an indeterminate concept (Giuliani & Brännström, 2011), goodwill might be defined as an intangible asset generated as a consequence of the acquisition of a company by another company, being the latter forced to recognize *“the portion of the purchase price that is higher than the sum of the net fair value of all of the assets purchased in the acquisition and the liabilities assumed in the process”* (Hargrave, 2021). The main problem of recognizing a “questionable” goodwill is that it is subjected to an impairment test, so the value of the company might be affected by the subsequent reporting of losses on the impairment of goodwill.

Furthermore, and as it will be seen throughout the following pages, the GPs force portfolio companies to issue additional debt in order to distribute among themselves exorbitant special dividends, sending the company to an almost inevitable demise. This situation gives rise to further questions that should be answered. How can banks allow these companies to assume increasingly higher levels of debt? Do they not know that it is almost impossible that the portfolio company will repay such high amounts of debt? The answer to these questions might be very obvious, but it is downplayed by everyone with interests in the business: banks encourage PE firms to carry out LBOs because they receive extraordinary fees for brokering deals and borrowing debt (Kosman, 2010). In fact, this combination of drawbacks shows many similarities with the effects of the 2007 mortgage crisis.

If these facts were not enough, the “magnificent management policy” suggested above consists basically of administering the company through exhaustive cost-reduction policies. These policies are developed by the recently appointed management, which does not last too long because of the extremely high CEO turnover in the PE industry. According to a survey made by AlixPartners (2017), around 58% of private equity CEOs are replaced within the first two years since the takeover (Cole, 2020). This “temporal” management is ready to carry out critical policies such as firing employees, reducing the quality of its products, reducing R&D investment, raising prices, reducing customer service, or stripping the company’s key assets (Kosman, 2010). Through all these activities, as GPs squeeze the portfolio company in order to save costs, the company becomes “cripple” and it loses operational effectiveness. Therefore, the portfolio company may face the risk of bankruptcy in the long term, but the GPs are only interested in the imminent profitability of the company. Consequently, PE firms usually manage their companies focusing only on the short term, disregarding the long-term viability of the company. The singularity of this process is that PE firms take practically no risks in the LBOs, as they invest a minor amount of money into their deals. The main victim of these activities is, as always, the society, especially the employees and the different stakeholders of the portfolio company. According to Forroohar (2017), *“if markets are an ocean, PE firms [...] are the great white sharks that have perfected the use of debt, leverage, asset stripping, tax avoidance and legal mechanisms to maximize profits for themselves at the expense of almost everyone else – their investors, their limited partners, their portfolio companies and the workers in them, and certainly society at large”*.

The relationship of the GPs with everyone else - including the LPs - is based on a conflict of moral hazard. According to a specific agreement typical of the PE industry – called “carried interest” -, the GPs will receive the 20% of the company’s returns if the fund achieves a “hurdle”, that is usually an 8% rate of return (Appelbaum & Batt, 2014). This structure encourages the GPs to take high risks, but with other people’s money. In finance, a way to assume high risks in order to increase profitability consists of issuing debt. This is called the “financial leverage effect” (Palepu, 2019). The higher the debt, the higher the profits the company may obtain but the higher the risk too (Fernández & García, 1992). The GPs contradict this basic finance theory, because they only assume the positive side of the story, as they have contributed with only 1% of the equity, but they are willing to force high risks in order to obtain prodigious returns. If the investment

fails, GPs have little at stake even though the company may go bankrupt. In other words, and to simplify the explanation, General Partners take advantage of Limited Partners, while both General Partners and Limited Partners take advantage of the company's stakeholders. It is a "treacherous game" in which the main victims are, as always, those stakeholders that do not participate directly in this conflict of interests.

PE firms' businesses can be comparable with the assumption of a housing mortgage, as in both cases the acquirer uses debt to finance the acquisition. There is, however, a crucial difference between them. While in the acquisition of a house the acquirer repays the debt with its own funds; in the acquisition of the target company, the acquirers require the own target company to repay the debt assumed by themselves.

3. SPECIAL DIVIDENDS IN PRIVATE EQUITY FIRMS

3.1. Ordinary dividends vs. special dividends

A company's dividend policy can be defined as a relationship of exchange between the management and the shareholders of a company, by which the management decides the amount of money from the net income that they are going to use to retribute shareholders in proportion with their share ownership (Pindado, 2012). This way, managers reward shareholders, who always want to obtain a profitability from their investment in the company. It is evident that the more money the management uses to retribute shareholders, the less money the company has to carry out investments that may help the company to grow. Therefore, managers usually find themselves in a conflict of interests, as they want the company to grow, but they also need shareholders to be satisfied with the profitability they receive. In any case, the dividend policy is discretionary, as it is based on information and expertise that only managers have, so they can adjust it and a tribunal cannot oblige managers to distribute dividends the way shareholders want (Fox, 2020). Furthermore, as dividends are uncertain, managers have to make, beforehand, the decision about which percentage of the net income is going to be reinvested in the company and, on the other hand, which percentage is going to be paid out as a dividend (Sáez & Gutiérrez, 2014).

The most common method that companies use to retribute shareholders consists of paying a cash dividend once the accounting period has finished (Pindado, 2012). Once the companies have obtained a net income in their income statement, they retribute

shareholders with a certain percentage of it (for example, the company establishes that this year shareholders will receive 20% of net income). Following this policy, the better the results of the company, the higher the dividends that shareholders receive. Due to the proportionality of the distribution, this policy is considered by many authors as the optimum one, as dividends are distributed depending only on the net income (Pindado, 2012). There are some other - less popular - policies used by companies to distribute dividends, such as distributing a fixed amount (for example, 1,000,000 euros per year), a variable percentage (depending on the year) or a residual amount (once the company has carried out all its investments). Finally, it is also worth to highlight the importance of the interim dividends, which are dividends distributed along the year before knowing the net income. These dividends are based on the positive expectations of obtaining considerable profits in the income statement of that year (Barone, 2020).

This project is focused on a different kind of dividend – not included above – which is the special dividend. A special dividend can be defined as an one-time cash distribution that it is not as regular as ordinary dividends and that it is not usually based on the net income (Price, 2021). Consequently, as special dividends do not tend to be justified by the net income, the empirical research carried out for the second part of this project will show how special dividends are mainly based on equity's safety cushion. This safety cushion is formed basically by the company's retained earnings and the share premium. The alteration of this equity's safety cushion might compromise the company's viability, as it is considered as the "lifesaver" that allows the company to stay afloat in times of financial difficulties (Financial Talking, 2020). As this cushion may be affected by the distribution of special dividends, the collateral meaning of their announcement might be really dangerous for the company. However, a special dividend is usually announced by the board of directors with the objective of keeping shareholders satisfied, and these dividends tend to reward them in a superior way than normal dividends. The connotation of the announcement of a special dividend may vary a lot depending on the justification the company gives to it, and an unjustified special dividend may be interpreted by shareholders as a dangerous signal that tries to hide other problems of the company (Brickley, 1982). Companies are more likely to announce special dividends in times of recession or in bear markets, as making an announcement like this in tough times may be seen by their shareholders as an indicator that the company is well-managed and that it can afford to pay off their liabilities with enough solvency (Beladi et al, 2016).

3.2. Special dividends in PE-target companies

3.2.1. A general overview

The connotations that special dividends have in PE firms go beyond their theoretical concept, as they are conditioned by the intrinsic meaning of an LBO. As aforementioned before, an LBO is a special mechanism used by PE firms by which a target company is purchased using a significant amount of borrowed funds. In this situation, the merger between Target and Newco results in a portfolio company with an outstanding level of liabilities. On the other side of the balance sheet, one of the main assets of this portfolio company is a “questionable” goodwill, as PE firms tend to overpay when carrying out a leveraged takeover (Froud & Williams, 2007). So, as everybody may notice at first sight, the portfolio company is not well-balanced, as goodwill may be subjected to impairment and the burden of having such a level of liabilities is considerable. However, despite these initial drawbacks, the GPs have promised the LPs some profitability, and they obtain it by following intensive cost-reduction policies focused on the short term (Kosman, 2010). The profitability obtained through those cost-reduction policies, together with the amount obtained by selling the company at the end of the holding period, allows the GPs to retribute the PE fund (formed by the LPs and by the GPs themselves). But the GPs will never reluctantly accept to receive only these standardized returns, so here come into play the famous concept of special dividends.

The GPs are the owners of a company that may be profitable in the short run, but which may face serious financial difficulties in the long run. Therefore, apart from being able to sell the company at the end of the holding period, the GPs are eager to extract cash from the portfolio company in the short run. One way to extract this cash is through special dividends. However, the company does not accumulate substantial amounts of cash in its bank accounts. Thus, the preliminary step before distributing special dividends consists of obtaining the necessary cash. This necessary cash can be obtained through the issuing of for more and more debt, increasing considerably the liabilities of the portfolio company. This situation may be seen as unrealistic, as a company that accumulates a considerable amount of debt asks for even more debt, but banks allow these movements because they might receive extraordinary fees by PE firms for brokering deals and borrowing debt (Kosman, 2010). The “technique” of issuing debt in order to obtain cash to distribute among themselves special dividends is called dividend recapitalization – or dividend recap – and it changes completely the capital structure of the portfolio company

(Fox, 2020). In fact, dividend recapitalizations are probably the optimum method for GPs to obtain a cash return in a PE investment, as they pull out cash from the company, but preserving their ownership position (Fox, 2020). Anyway, issuing debt is not the only method that provides the company with the necessary cash, as asset stripping is another useful technique carried out by GPs in order to obtain the necessary cash to proceed with the payment of special dividends. According to Harford & Kolasinski (2014), around 25% of the PE-backed portfolio companies have distributed special dividends to their respective PE fund. However, the empirical research carried out in the second part of this project shows a very different reality in where special dividends are more common than what it seems.

Once the portfolio company has obtained the necessary cash, the GPs have to distribute it among themselves. In order to carry it out, the distribution of cash has to be justified by a drop in the right side of the balance sheet. Here comes into play the concept of equity's safety cushion, formed by the retained earnings and the share premium. Therefore, the extraction of cash is based on the equity's safety cushion, which suffers a reduction in order to justify the distribution of special dividends. This reduction of the cushion may have fatal consequences for the portfolio company, as its solvency may be compromised due to this lack of reserves.

3.2.2. Dividend recapitalizations

A dividend recapitalization is a leveraged operation by which a company changes its capital structure by borrowing debt in order to pay out a special dividend to its shareholders (Fox, 2020). These payments are, in fact, debt-funded dividends, as the necessary cash is obtained by borrowing debt. Dividend recaps are often carried out shortly after the target company is acquired (Appelbaum & Batt, 2014), as it might be the moment in which it is easier for the GPs to ask for more debt. In other words, it may be less suspicious for GPs to ask for debt just after acquiring the portfolio company than once the company is starting to face financial difficulties due to its constant indebtedness. Another fact that supports the evidence that dividend recaps usually take place during the first years after the takeover may be that the GPs are eager to recover their investment as soon as possible, in order to be able to "play" with the LPs' funds and the borrowed debt without assuming any risk for themselves. To prove these assumptions, Canderle (2016) made a research in which he demonstrates that the shorter the investment holding period, the higher the returns for the PE-fund. The justification that underlies this research is

based on the concept of time value of money, by which the GPs are “obsessed” to get out of the investment as soon as possible.

This exclusive focus on the short run can be easily perceived in the case of Simmons Bedding (Phalippou, 2017), a company that suffered six Secondary Buy-Outs in a row since being first acquired by Wesray Capital in 1986. In fact, it is probably the most famous case of PE mismanagement in the US. In the early 1980s, Simmons Bedding was a well-known consumer brand, devoted to the fabrication of mattresses and other bedding products. Nonetheless, the PE industry saw a good business opportunity in Simmons Bedding, as the company was held by a total of seven PE consortiums along 23 years until its bankruptcy in 2009. Through this succession of SBOs, many financial intermediaries obtained a huge benefit from these operations, while the main victims were, again, the employees of the company, as the company suffered considerable layoffs between 1986 until its bankruptcy in 2009. Anyway, the different GPs took the most of the situation, and they carried out different dividend recapitalizations in the middle of this succession of SBOs. The most important dividend recapitalizations were carried out by Thomas H. Lee Partners, the first one in 2004, by which they distributed among themselves \$137 million in special dividends (after making the leveraged takeover in 2003 of \$1.1 billion in which the 65% was debt); and the second one in 2007, by which they distributed \$238 million in special dividends after issuing debt for \$300 million. In total, PE firms extracted from Simmons Bedding an aggregate amount of \$750 million in 23 years (more than 13 times the cash the company had at the time of their departure), leaving the company to an inevitable bankruptcy in 2009. Therefore, this example shows how easily an stable and well-known company may go from the top to bankruptcy in less than 25 years. As a matter of fact, the only crime committed by Simmons Bedding was being managed by greedy and unscrupulous PE firms that have the only objective of earning millions and millions of dollars at the expense of every stakeholder else.

The obsession with short term is reinforced by several internal mechanisms of the PE markets. During a PE fund’s typical life span of around four years (Phalippou, 2017), the LPs cannot withdraw the capital previously provided and new investors are not allowed to join the fund (Appelbaum & Batt, 2014). Nevertheless, the LPs expect to obtain some returns some years after their initial investment, so the GPs have the necessity to satisfy their pretensions. The main source of income for the LPs may be achieved once the portfolio company is sold at the end of the holding period at a superior price, but they

will also claim to obtain some profits during the holding period. In this sense, GPs may be tempted to distribute special dividends to LPs, but they might also take the most of the situation to distribute those dividends among themselves too. Furthermore, PE firms have created a new theoretical concept in order to justify these massive distributions, which is a kind of “financial engineering” (Appelbaum & Batt, 2014). This new categorization is referred to the continuous and almost periodic use of dividend recapitalizations, high levels of debt and tax arbitrage as a way of life for the portfolio company since the moment the LBO takes place. Consequently, the GPs put aside the accomplishment of operational improvements that may effectively help the portfolio company to develop itself and grow in the market. Through this kind of financial engineering, they take advantage of boom times to enjoy the power of leverage. After putting a lot of pressure on managers to carry out aggressive cost-reduction policies, the GPs achieve their initial objective and lead the company to higher profit margins and short-term returns. However, this has little to do with operational effectiveness and increasing efficiency. In fact, this kind of financial engineering is based on the development of rent-seeking behaviours since the takeover. These rent-seeking behaviours consist basically of generating profits through changes in the capital structure and in the financing of the firm, but having nothing to do with wealth creation (in other words, “*generate social waste rather than social surplus*”). The objective of this behaviour is to magnify the returns for the GPs but, as always, at the expense of everybody else at the organization (Appelbaum & Batt, 2014).

Having seen the example of Simmons Bedding and understanding the concept of financial engineering, it is obvious that those dividend recapitalizations are not minor operations, as they provide GPs with millions and millions of dollars. The objective of the GPs is not only to recover their investment in the PE fund, but also to obtain millionaire profits that may allow them to carry out more and more takeovers in the PE market, being richer every year. They are creating a bubble that may explode someday, just as in the 2007 mortgage crisis. A recent study (Baker, 2021) proves that the health care companies in the US managed by PE firms have paid ridiculously high amounts of special dividends to the GPs. For example, Trident USA, a supplier of diagnostic equipment, went bankrupt in 2019 after driving into debt in order to pay out a special dividend of \$380 million to several PE firms. Prospect Medical Holdings, an enormous chain of hospitals along the US, paid out in 2018 a special dividend of \$457 million to

the PE firm Leonard Green & Partners, and since then the company has closed five facilities and fired more than 1,000 workers (Baker, 2021). Finally, the Hospital Corporation of America delayed its IPO in 2010 because of its uncertainty to achieve the expected target price, but at the same time the GPs issued debt to carry out three outstanding dividend recapitalizations that allowed them to gain a total of \$4.25 billion (Dowd, 2017). The consequence of these payments for portfolio companies is not always going bankrupt, but also becoming “cripple” companies that will never recover from that dividend recapitalization. This situation has given the chance to Kosman (2018) and Crehan (2020) to emphasize in their idea of zombie companies, which are companies *whose annual debt repayments are greater than the profits they are able to make from normal business activities*. These companies took the most of the low interest rates in the 2010s to avoid bankruptcy, but their profits are always lower than their debt repayments, so their operational effectiveness is almost null (Crehan, 2020).

This phenomenon of dividend recapitalization is relatively new, as it exploded in the US in the late 1980s (Froud & Williams, 2007). In any case, its effects are easily perceived in many firms in which a PE firm has carried out an LBO. On the one hand the GPs transfer resources from the portfolio company to themselves – and to the PE fund – instead of using them to improve the performance of the portfolio company. On the other hand, the same GPs put a lot of pressure on the portfolio company in order to develop cost-reduction policies and, at the same time, increase the efficiency and the value of the company. According to Standard & Poor’s (2014), it is obvious that dividend recapitalizations have terrible consequences for the portfolio company, as they *damage credit quality, may increase defaults, and may drive portfolio companies into bankruptcy*. Thus, dividend recaps entail many risks of default and bankruptcy for the portfolio company, as the amount used to retribute the GPs could have been invested in the company’s future growth, so the company may face problems to overturn the different downturns of the economy either in the short or in the long run. What is more, even a temporary decline in sales that reduces the portfolio company’s revenue may lead to discretionary layoffs and considerable pay cuts for workers (Appelbaum & Batt, 2014). In this sense, Moody’s tends to downgrade its opinion of companies that have recently carried out a dividend recapitalization, recognizing in this way the negative impact of the dividend recap on the portfolio company’s financial performance (Fox, 2020).

These critical consequences that dividend recapitalizations may cause on portfolio companies can be empirically observed with the example of Southeastern Grocers (Appelbaum & Batt, 2018). This company was a grocery chain owned by the PE firm Lone Star Funds since a \$660 million takeover through a LBO in 2005. After the acquisition, the GPs started a cost-reduction policy but, as investors challenged their non-rewarding policy, the GPs finally executed a dividend recapitalization in 2011 in order to reward LPs, but especially to distribute between themselves around \$500 million of special dividends (concretely, between 2011 and 2013 the GPs paid themselves and their investors a total amount \$838 million in dividends). The money that they looted from the company was, therefore, not used to make the company more competitive, so it started to have financial problems in 2012. And, what is more, the crippled company, meanwhile, became overdue with interest payments on the loans used to finance the special dividends (in fact, on a dividend recapitalization's loan of \$475 million, Southeastern Groceries was forced to pay \$205 million in interests in only four years). In order to make the situation even worse, in 2012, Lone Star Funds decided to buy out Winn-Dixie for \$590 million, adding by this way 660 stores and 63,000 employees to its conglomerate; and the PE firm also bought 165 stores in 2013 through a LBO of a total value of \$265 million. In this situation, by the year 2014, Southeastern Groceries had an unsustainable debt of \$1.32 billion (plus all the interests that were being continuously generated along the years), so it was clear that the company was sentenced to an inevitable demise. Searching for cash in a desperate attempt to repay the debt, the company accomplished an asset stripping policy by which they obtained gains of \$145 million, but this policy was like shooting themselves in their own foot, as the company became more and more inefficient. Therefore, the situation was completely unsustainable, and the company became bankrupt in March 2018, although it is true that they were able to exit bankruptcy in June 2018 (the new debt was "only" of \$600 million), but at that time 2,000 workers had lost their jobs. By the time the company bankrupted, Moody's Investor Service estimates that the GPs have took out a total of \$980 million through special dividends. In fact, this example shows how PE firms are ready to increase unstopably the bubble of debt in which their portfolio companies are immersed, destroying the firm's ability to be sustainable while at the same time they are gaining millions and millions thanks to that debt.

Having seen the dramatic consequences of dividend recapitalizations, it is clear that they are surrounded by controversies, even among the own PE investors.

Traditionally, the GPs have waited for an exit event - such as a trade sale, a Secondary Buy-Out or an Initial Public Offering - before generating a return (Phalippou, 2017). Only when the GPs are not sure that they are going to obtain a return through one of those traditional exit techniques, they turn to carry out dividend recapitalizations in order to recover their original investment (and even more). However, in recent times, this practise of carrying out early dividend recaps has become more and more popular between GPs, without taking into consideration the effects on the public opinion and the considerable risk of distress that this policy implies to the portfolio company. And, what is more, when the portfolio company becomes insolvent after a dividend recapitalization has been carried out, the GPs always allege the same argument: the company has entered into some difficulties because an unforeseen event has impacted the company's profitability (Phalippou, 2017). This argument is rather poor and unfair with the rest of stakeholders, as the GPs recover part of - or more than - their investment in the PE fund, while everyone else is losing something. In fact, the GPs, who are sat in the portfolio company's board of directors and who theoretically have the duty of taking care of the company and of all its stakeholders, are the ones who cause damage to everybody else in the company by issuing more and more debt to pay themselves special dividends (Canderle, 2011). In most financial bankruptcy cases in which a PE firm is involved, the LPs may lose a huge part of their investment, and the employees or other stakeholders of the portfolio company may lose their job or their source of income (Greenfield & Rossman, 2017). On the other side, the GPs may earn millionaire profits at the expense of everybody else. Canderle (2011 and 2016), criticizes severely this behaviour of GPs, considering that "*it is indecent to suck any spare cash of a well-run corporation in order to upstream dividends for the sole purpose of enriching a small number of investors*" and he wonders "*In what world can one behave unscrupulously towards the majority in order to serve a privileged minority?*". The moral conflict that emerges from this situation is more than evident, but it seems that some million dollars are enough for GPs to forget about any kind of morality.

This selfish attitude of the GPs may be perceived even though the portfolio company does not end bankrupted or transformed into a "zombie" company. This is the example of Warner Music (Kosman, 2010). This company was the fourth largest music company of the world in 2004 when it as acquired through a LBO by Thomas H. Lee Partners, an American PE company based in Boston specialized in leveraged buy-outs. The total amount of the LBO was \$2.6 billion, but obviously most of the takeover was

financed by debt. The first words of Edgar Bronfman Jr., new CEO of the company, were the typical ones that may fit in with the definition of PE given in the first epigraph of the project: “*Warner Music Group is well positioned to be extremely successful as an independent company, both creatively and financially [...] and we intend to move quickly to implement a strategy that will enable the company not only to meet the challenges of the current environment, but also to take full advantage of future opportunities*”. Anyway, since the acquisition of the company, the PE fund developed an intensive cost-reduction policy, by which they reduced the workforce of Warner Music from 5,300 to 3,800 in only three and a half years. Nonetheless, at the same time they were firing employees, they were borrowing impressive amounts of debt in order to both take advantage of the boom of digital music sources and to carry out dividend recapitalizations in order to distribute special dividends between themselves. In fact, the GPs received a total amount of \$1.2 billion between 2004 and 2007 as special dividends, a considerable higher amount than the one that they invested in the takeover. And, as if this were not enough, the GPs also received \$73 million from Warner Music in management fees, increasing considerably their profits from the investment. Finally, in 2011, Thomas H. Lee Partners sold it to Access Industries for \$3.3 billion, obtaining a formidable profit apart from the outstanding dividends that they have received during their seven years as owners of Warner Music.

3.2.3. *Asset stripping*

Borrowing is not the only technique used by GPs to obtain the necessary cash in order to distribute special dividends among themselves. It is true that recapitalizations might be the easier way for them to obtain cash, as they only need to ask for more debt to a bank that collaborates with them or that has interests in the PE industry. Asset stripping is another mechanism commonly used by PE firms to get cash for the portfolio company and, subsequently, extract it via special dividends. Recent studies in transitional economies have proved that asset stripping is *likely to take place in large and powerful companies with intermediate profitability* (Jeppesen & Møller, 2011). Asset stripping consists basically of selling the assets of a company in order to obtain cash by which distribute dividends between the shareholders (Chen, 2021). In the PE business, the sale of assets can be analysed from a positive and a negative point of view. On the one hand, during the first years of the holding period, the sale of assets from lower performing activities may improve the overall efficiency of the portfolio company (Wright et al,

2009). On the other hand, the sale of key assets of the portfolio company may drive the company to a considerable reduction of its operational effectiveness (again, the concept of “zombie” companies). In the PE business, as the GPs are interested in obtaining as much cash as possible and they are not focused on the long term, asset stripping tends to affect the key assets of the portfolio company (Appelbaum & Batt, 2014).

Through asset stripping, the GPs get rid of non-current assets that the portfolio company may use in its daily operations in order to gain cash through their sale, but the cash obtained is distributed between themselves through special dividends. The functioning is the same as dividend recapitalizations, but in this case the portfolio company loses part of the capital that keeps the company alive. In other words, asset stripping destroys value (Weiss & Wruck, 1998). Therefore, the portfolio company becomes inevitably crippled and its operational effectiveness will decline considerably. In fact, as dividend recapitalizations, asset stripping allows the GPs to extract resources from the portfolio company at the expense of everybody else, leaving the company to a permanent fight for survival, without possibilities of growing in the market. Here, the concept of “zombie” companies is more than appropriate, as portfolio companies become “cripple” firms unable to carry out their operational daily activities.

3.2.4. Conclusions

After having analysed all the connotations of special dividends in the PE industry, it seems that their distribution to the GPs is more than counter-productive to the portfolio company acquired by the PE fund through an LBO. The main problem of those distributions, apart from their unfairness, is that the portfolio company does not have the necessary cash to afford them, so the company has to find a way to obtain it. The cash necessary to distribute special dividends is obtained through borrowing debt (dividend recapitalizations), asset stripping and cost-cutting policies. Then, once the necessary cash is obtained, the GPs use the equity’s safety cushion to justify the distribution of these special dividends. Therefore, distributing special dividends means that the portfolio company destroys value.

The GPs loot the portfolio company via special dividends, and then they take the most of the situation to exit the PE-backed company once they have crippled it without any possibility of recovery. As always, the main victims are the employees and the rest of stakeholders of the company. The exhaustive cost-reduction policies - together with the inevitable decline of the operational effectiveness - usually give effect to the

restructuring of individual workplaces, the reduction of employment security, closures, layoffs and massive outsourcing (Greenfield & Rossman, 2017). In fact, PE firms usually view portfolio companies as a “bundle of assets”, without taking into consideration that they are also a place of employment, a service-provider for many people, a manufacturer of goods used by many customers, etc. Probably, this lack of humanity and social vision is the main responsible of the bad reputation that PE firms have around the world.

This problem, however, is not only focused on how much damage GPs cause to the portfolio companies, but also on why GPs find themselves with enough legitimacy to appropriate millions and millions of dollars through special dividends. In fact, most of the GPs supervise very few employees and they do not intervene decisively in the generation of revenue, but still they pay themselves millions of dollars annually in special dividends (Canderle, 2011). It is true that, during the first years, the portfolio company may grow through a better short-term management and through intensive cost-reduction policies. However, later on the company finds itself in such a wobbly position that there is little job creation and the company will struggle to survive against such indebtedness. Therefore, if the LPs had to readjust their expectations in the company, it would seem appropriate for the GPs’ compensation policies to be reviewed too.

This project is focused on the consequences that special dividends have on portfolio companies, but also on the techniques used by Private Equity firms to obtain the necessary cash to distribute those special dividends. From an accounting point of view, this process imply the pertinent increase in cash and in liabilities. However, once the cash is obtained, the next step in the process consists of distributing that cash between the GPs via special dividends. This step implies getting rid of the cash obtained, but it also entails a reduction on the left side of the balance sheet (equity or liabilities). It is obvious that in most cases the GPs do not declare expressly the special dividends that they have just distributed among themselves (Fox, 2020). In fact, as it will be seen throughout the empirical part of the research, the distribution of special dividends is fundamentally charged to the company’s equity’s safety cushion. It is extremely important to understand this critical difference – between the sources of obtaining cash and the sources of distributing that cash – before starting with the empirical research. Furthermore, there are other different techniques used by the GPs to enrich themselves from the portfolio company, such as the management fees and the aforementioned “carried interest”, but they are not the object of this research.

3.3. Legal constraints for the distribution of special dividends in the US, Europe and Spain

After studying the negative connotations of special dividends in the PE industry, now it is time to analyse the legal regulation of these operations in the United States, the European Union and Spain. Due to the multiple problems that PE firms cause to portfolio companies, it may be fair that these different legal systems contain some regulations about this issue. Therefore, the objective of this analysis is to determine the level of protection that portfolio companies have against the payment of special dividends.

Are really those special dividends under the law? Does the law effectively protect companies against these distributions? Has the equity's safety cushion enough legal protection? The answer to these questions needs to be answered through the corporate law and the PE-specific law of the United States, the European Union and Spain. They are three different environments in where companies develop their operational activities, but the spirit of the law must be the same, protect companies against the distribution of special dividends. Although there are some considerable differences between the corporate law of the United States and the corporate law of the European Union, they are much smaller than often assumed by everybody (Cools, 2005). The main difference resides in the company's distribution of powers, as the US system gives almost full powers to the board of directors, while in the EU system the power of shareholders is much higher (Cools, 2005). Therefore, as the equity's safety cushion is basically formed by shareholders' funds (Finance Talking, 2020), it may seem at first sight that EU's corporate law should be more restrictive on that issue.

The US corporate legislation on special dividends is very simple, as corporate law establishes that, when distributing dividends, the board of directors must leave enough equity in the company in order to ensure that assets are bigger than liabilities. In order to comply with this legal requirement, the American system had traditionally used the *impairment of capital test* approach (Fox, 2020). According to this approach, managers are required to preserve the legal capital - the company's shares multiplied by their par value - before distributing dividends. However, this measure has not been very efficient because of the slight amount that legal capital represents from a firm's equity (Armour, 2006). In response to that failure, during the last years a new approach has been developed in the US with the objective of restricting more severely dividend distributions (Fox, 2020). This approach is based on two solvency tests that must be satisfied jointly. The

first test, called the *balance sheet insolvency test*, prohibits any distribution by which the company's assets become less than the company's liabilities and any liquidation preferences. The second test, called the *cash flow insolvency test*, is more focused on whether the company will be able to pay its liabilities on time once the dividend distribution has been made. This second approach is only applied in some American corporate law regulations, but it may be interesting to analyse the success that this approach might have in some countries of the European Union.

Talking about the PE-specific regulation in the US, each State has its own regulation, which generally is not very restrictive (Misner et al, 2020). State law generally forbids the payment of dividends by a PE firm only if the portfolio company would not be able to pay its current debts and liabilities (Rowe & Kliger, 2020). However, the Volcker Rule, approved in 2020, may be the first step on the development of PE restrictive policies. The Volcker Rule is a *federal regulation that generally prohibits banks from conducting certain investment activities with their own accounts and limits their dealings with hedge funds and PE funds* (Chen, 2021). Anyway, there is not a federal PE-specific legislation that regulates the payment of special dividends to the GPs in the US.

In the European Union, company law is mostly recorded on the Directive (EU) 2017/1132 of the European Parliament and of the Council relating to certain aspects of company law. As a legal clarification, every EU directive must be transposed by each Member State in order to be legally in force in that Member State. This EU Directive regulates the distribution of dividends in article 56.1, which establishes that *no distribution to shareholders shall be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are or, following such a distribution, would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed*. Therefore, this directive may have some similarities with the American impairment of capital test, as it is more focused on protecting the social capital rather than the firm's solvency to repay its liabilities. In addition, article 56.3 records that *the amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes*. These restrictions on distributions may be perceived as very strict and useful, but the empirical evidence shows otherwise.

European Union's specific PE-regulation exists in the EU's Alternative Investment Fund Manager Directive (legally named as Directive 2011/61/EU), which is referred to the *financial regulation of hedge funds, private equity, real estate funds, and other "Alternative Investment Fund Managers" (AIFMs) in the European Union*. This directive is the most specific EU legal text that regulates the distribution of dividends in the PE industry. Article 30 establishes that, when a PE fund acquires control over a non-listed company, the PE fund *should, for a period of 24 months following the acquisition of control of the company [...] not be allowed to facilitate, support or instruct any distribution*. The dividend distributions expressly forbidden during the first two years, according to article 30.2, are the ones by which the net assets become lower than the subscribed capital plus the reserves, and the ones that exceed the amount of the net income of the last year. Consequently, in the EU countries that have transposed the directive (such as Spain), the GPs are limited to distribute special dividends during the first two years of the investment. However, there is nothing that may prevent them to carry out such distributions after the aforementioned period of two years has finished. And, what is more, during the first two years of the investment, the GPs are able to distribute dividends anyway, as long as they respect article 30.2 Directive 2011/61/EU. Article 22 of the Directive 2011/61/EU, which is referred to the duty of transparency that the board of directors must have in their accounts is also crucial. In this way, the annual report of the company shall contain the total amount of remuneration gained by the board of directors if those actions have a *material impact on the risk profile* of the portfolio company. Consequently, according to this directive, the GPs must declare the special dividends they receive - as they have a considerable impact on the risk profile of the company - but the subsequent empirical research will show how the theory has nothing to do with the reality.

In Spain, company law is recorded on the 1/2010 Corporate Enterprises Act. The principal points of interest for this research are focalized in articles 273 to 278, as they are the ones that control the distribution of dividends. According to article 273, dividends can only be distributed based on the net income or on freely available reserves, if and only if *the value of the corporate equity is not, or as a result of such distribution would not be, less than the company's capital*. Here, it can be checked again that both the European Union and Spain follow the American impairment of capital test, as it is more focused on protecting the social capital rather than the firm's solvency to repay its liabilities. Following this article, in the event of losses from previous years that reduce

corporate equity to less than the company's capital, no distribution shall be made and the net income shall be used to compensate those losses. According to article 275, dividends shall be distributed proportionally with the contribution of every shareholder in the company, so they cannot be distributed discretionally. Finally, article 278 records that, in the case any distribution breaches the aforementioned norms, the amount illegally distributed must be reimbursed by the recipient shareholders if the company is able to prove that *such recipients were aware, or under the circumstances could not have been unaware, of the undue distribution of the dividends.*

As a more recent reference of corporate law, it is also worth to highlight the current importance of the 18/2020 Royal Decree-Law, which has regulated some issues of labour law related with the coronavirus pandemic. According to this Royal Decree-Law, the Spanish corporations that have invoked the Record of Temporary Employment Regulation (in Spanish, the ERTes) would not be able to distribute dividends on the economic years in which the ERTes have been applied, unless they have previously paid the amount that corresponds with the pertinent exoneration of the Social Security's fees. This limitation does not apply to companies that have invoked the ERTes but have less than 50 employees. In any case, this new regulation, elaborated to alleviate the economic and social effects of the coronavirus pandemic, may be useful to prevent the fraudulent use of the ERTes by PE firms, as they are not allowed to invoke this mechanism while at the same time distribute prodigious dividends between them.

Private Equity has also specific regulation in Spain in the Act 22/2014 on Private Equity Entities, which is the transposition of the EU's Alternative Investment Fund Manager Directive. Following the guidelines from the AIFM Directive, article 71.4 regulates the distribution of dividends during the first two years after the PE fund has carried out the takeover of the target company. Therefore, during the first 24 months the portfolio company cannot distribute dividends *when the value of the corporate equity is, or as a result of such distribution would be, less than the company's capital plus both the legal and the statutory reserves.* In addition, those distributions are also forbidden when such dividend distribution exceeds the amount of the net income, plus the profits from previous years not distributed, less the losses from previous years and less the provisions to both the legal and the statutory reserves. In other words, this Act basically transposes to the Spanish legislation the same content previously analysed in the AIFM Directive, so the Spanish specific-PE legislation is mainly the same as in all the European Union.

4. EMPIRICAL RESEARCH

4.1. Objectives of the research

Once the negative connotations that special dividends might have in PE-backed companies have been deeply discussed in the first part of this project, I now carry out the empirical part of the research, which is focused on the Spanish case. The objective of this empirical research is to test the negative effects that special dividends have in Spanish portfolio companies acquired by PE funds. All these negative effects have been explained in the previous section of this project, and now I contrast the theory with the empirical evidence.

The empirical research starts with a descriptive analysis of the results obtained from the sample. In this section, some of the most notorious and significant results obtained from the sample are exposed. The descriptive analysis is useful to give a first impression about the negative consequences of the distribution of special dividends in the PE industry. Next, I test the hypothesis that the distribution of special dividends in PE-backed companies is significantly common, comparing it with the benchmark stated by Harford & Kolasinski (2014). Finally, I study the relationship between special dividends and bankruptcy. Namely, I test the hypothesis that the probability of subsequently go bankrupt is higher for companies that have paid a special dividend. For that purpose, I estimate two different regression models.

A positive answer to these questions would mean that the practices developed by the GPs in their PE-backed portfolio companies are detrimental for their long-term viability. What is more, the existence of correlation between the distribution of special dividends and bankruptcy would be a serious blow for the already bad reputation of the Private Equity business model in the world.

4.2. The sample

In order to carry out this empirical research, I have selected a sample of 106 Spanish companies acquired by a PE fund through a Leveraged Buy-Out between 1996 and 2011. These companies are the portfolio companies that resulted from the merger between Target and Newco after the takeover was concluded. This sample has been obtained from an extensive database created by the Business Management Department from the Public University of Navarre.

I have created my own database formed by the 106 companies of the original database (Annex 1). In this new database, I have taken some information included in the original one, such as the year in which the LBO took place and whether those companies have distributed special dividends or not. Then, the toughest part of my individual research has been focused on checking whether the effect of those distributions of special dividends can be perceived in a balance sheet. I have collected this information using SABI, a specialized database to which the UPNA students have a free and unlimited access. SABI provides users with economic and financial information about Spanish and Portuguese companies. I have also used this specialized database to check, one by one, whether the 106 portfolio companies of the sample have gone bankrupt or not. Thus, my global database contains the corporate name of the 106 companies; the year when the LBO took place; whether these companies distributed special dividends or not; and whether the companies have gone bankrupt or not. This global database would be useful to carry out both the hypothesis test and the logistic regressions.

However, to carry out a descriptive analysis of the problems that special dividends imply, I need to obtain more concrete information about the portfolio companies that have distributed special dividends. Therefore, I have created a separate database that includes only the 42 companies from the sample that have distributed special dividends (Annex 2). I have recorded different information from SABI. The data I was most interested in was basically the year in which the first special dividend distribution was carried out and the equity's safety cushion account that was used as a source of cash distribution. I have also calculated the percentage of reduction in the equity's safety cushion - and the percentage of the variation in liabilities - the same year that the special dividend distribution took place. Finally, in order to verify the usefulness of the Spanish corporate legislation, I was interested in determining the amount of equity and the amount of social capital that remained in the portfolio company after the special dividend had been paid out.

Finally, I have also created another database in order to elaborate the logistic regressions needed to test the relationship between special dividends and bankruptcy. These regressions are elaborated using data from the 106 PE-backed companies of the sample (Annex 3). The data included in this database is whether the company has distributed special dividends, whether the company has gone bankrupt and the pertinent ratios needed to elaborate the logistic regressions.

4.3. Data analysis

The data analysis starts with a descriptive study of the results obtained from the sample. From the 106 PE-backed companies that make up the sample, 42 of them (39.62%) have distributed special dividends. Of these companies, 22 (52.38%) ended up bankrupted. From the 64 PE-backed portfolio companies that did not distribute special dividends, a lower percentage (40.63%) ended up bankrupted. However, the analysis of the relationship between special dividends and bankruptcy is going to be treated at the end of this empirical research through logistic regressions. Consequently, the descriptive data analysis is focused on the study of some variables obtained from the sample of 42 PE-backed companies that have distributed special dividends among their respective PE funds. As it has been previously explained, the objective of this analysis is to make a first impression about the negative consequences that the distribution of special dividends in the PE industry imply to portfolio companies.

First, 77.27% of the 22 PE-backed portfolio companies that distributed special dividends and then went bankrupt had previously complied with article 273 of the Spanish 1/2010 Corporate Enterprises Act. This article says that dividends can only be distributed if and only if *the value of the corporate equity is not, or as a result of such distribution would not be, less than the company's capital*. In other words, the company's equity must always be higher than the company's social capital. Therefore, due to the high percentage of portfolio companies that have gone bankrupt, even though complying with Spanish corporate law, I can affirm that the usefulness of article 273 of the Spanish 1/2010 Corporate Enterprises Act is more than questionable. In this sense, Spanish corporate law is not a guarantee for the protection of portfolio companies against the distribution of special dividends. In fact, social capital usually represents a very small percentage of a company's total equity, so the constraints imposed by article 273 are very easy to comply with. As I will claim in the subsequent conclusions, a legal reform of the Spanish corporate law based on the balance sheet insolvency test and on the cash flow insolvency test might be necessary in order make a more restrictive regulation on this issue. Moreover, as this sample records data from 1996 to 2011, it remains to be seen whether the EU's Alternative Investment Fund Manager Directive has been useful or not.

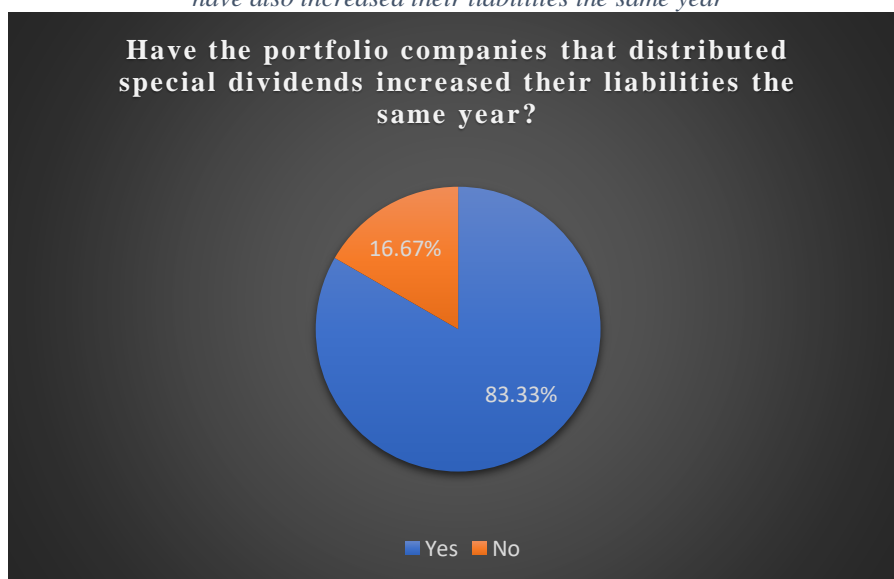
Figure 1: Graphic that illustrates whether bankrupted portfolio companies have complied with the legislation or not



Source: Compilation based on the sample

Second, in 83.33% of the cases, the Spanish PE-backed portfolio companies that have distributed special dividends, have also increased their liabilities in the same year of the distribution. This is a clear evidence that one of the principal techniques used to obtain the necessary cash for the distribution is the “dividend recapitalization”, that is, the borrowing of additional debt in order to pay the special dividends. Therefore, when a dividend recapitalization is carried out, the liabilities of the portfolio company (either current or non-current) increase considerably, and this is the pattern that the sample reflects too.

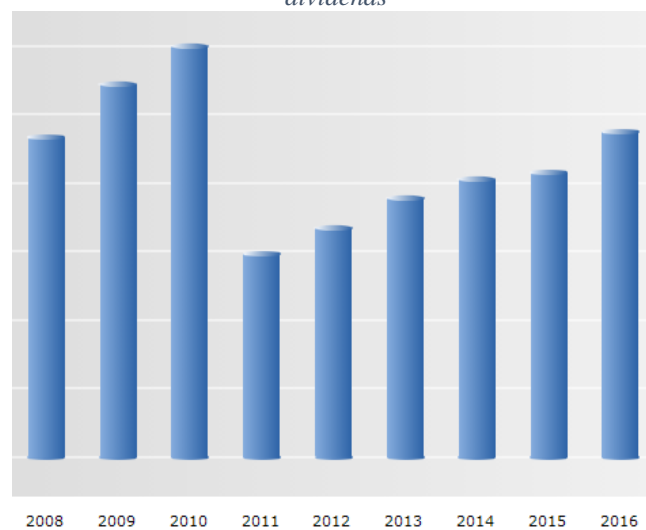
Figure 2: Graph that illustrates whether the portfolio companies that have distributed special dividends have also increased their liabilities the same year



Source: Compilation based on the sample

Out of the 42 PE-backed companies that distribute special dividends, the average reduction of the equity's safety cushion is 43.69%. This means that, on average, when a portfolio company distributes special dividends, its equity's safety cushion is reduced to almost half. This situation could not be more dangerous for portfolio companies, as the loss of half their equity's safety cushion may imply solvency problems and entering into the risk of receivership. The median decrease in the equity's safety cushion is 36.01%, which means that half of the reductions were more substantial than that benchmark. Figure 3 shows a graphical explanation of this reduction in a company's safety cushion.

Figure 3: Typical evolution that suffers the equity of a portfolio company after the distribution of special dividends



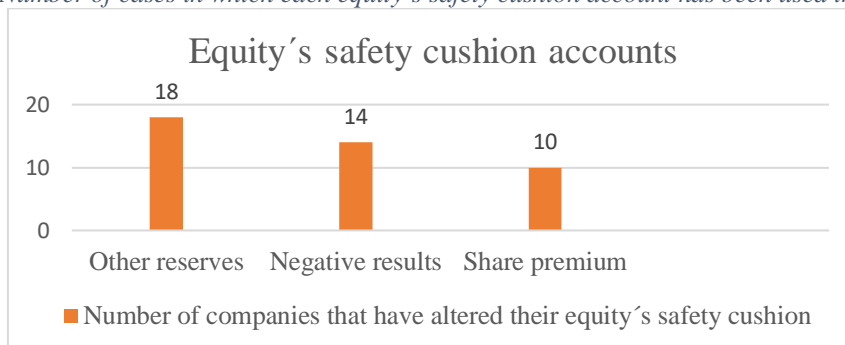
Source: SABI

Figure 3 shows how the equity's safety cushion is almost halved, and since that moment the company enters into a constant fight for survival against possible financial difficulties. In this situation, the portfolio company may suffer from a huge increase in its financial risk. In fact, the company might never recover from this reduction on its equity's safety cushion, and even a temporary decline in sales that reduces revenue may lead to downsizing, layoffs and salary cuts. Consequently, and despite complying with article 273 of the Spanish 1/2010 Corporate Enterprises Act, many Spanish portfolio companies assume a huge financial risk carrying out these practices.

The empirical evidence has proved that the decrease in the equity's safety cushion of the portfolio company when distributing special dividends is more than considerable. Now, the research is focused on analysing which accounts from the equity's safety cushion are the main used ones as a source of distributing cash. From the sample of the

42 Spanish PE-backed companies that have distributed special dividends, 42.86% have altered “other reserves”, 33.33% have altered the “accumulate negative results from previous years”, and 23.81% have altered the “share premium”.

Figure 4: Number of cases in which each equity’s safety cushion account has been used in the sample



Source: Compilation based on the data above mentioned

With this data, it can be assumed that, firstly, PE-backed portfolio companies obtain the necessary cash through different sources such as borrowing debt (for dividend recapitalizations). Then, in order to distribute that cash, the managers of the company take the most of the equity’s safety cushion to justify the distribution. According to the sample, in Spain the most used equity’s safety cushion account to make such distribution is “other reserves” (“retained earnings” according to the International Financing Reporting Standards). From this data, I can make a illustration about how an accounting journal entry has to be made in order to obtain the necessary cash and justify the distribution of special dividends. The illustration is the following.

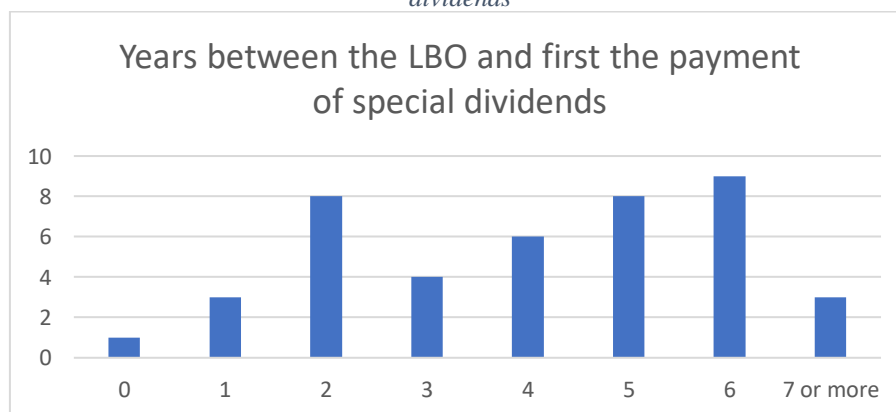
General Journal

Date	Account Title and Explanations	Amount (Rs)	
		Debit	Credit
	Cash	1,000	
	Liabilities		1,000
	Retained earnings	1,000	
	Cash		1,000

This journal entry shows the increase in liabilities and the decrease in the equity’s safety cushion, while at the same time the necessary cash is firstly obtained and then distributed. It might be the common pattern used by portfolio companies’ management to carry out the distribution of special dividends.

The general thought about the duration of PE investment in target companies is that they are short investments only focused on the short term. In order to test this assumption, the sample provides us with the necessary information to determine how many years have passed in each case between the LBO and the first distribution of special dividends. From the 42 Spanish PE-backed portfolio companies that have distributed special dividends, the first distribution of special dividends is carried out, on average, 4.26 years after the takeover. The median is 4 years, which means that half of the distributions were carried out during the first four years after the LBO, while the other half were carried out more than four years after the LBO took place. Probably, the most meaningful data that we can extract from this variable is the standard deviation, which is 2.39 years. Therefore, we can assume that there are some cases in which the distribution takes place soon after the takeover; while in other cases the GPs are more focused on developing cost-reduction policies first. I again repeat that the effects of the AIFM Directive, which limits the distribution of special dividends during the first two years of the investment, cannot be perceived in this sample because it includes data only from 1996 to 2011.

Figure 5: Chart that shows the years that have passed between the LBO and the first payment of special dividends



Source: Own elaboration

This graph shows the temporal difference that exists between the LBO and the first distribution of special dividends. To analyse this temporal distribution, a confidence interval for the mean with a 95% level of confidence has been made. From this interval, I am 95% confident that the true average number of years between the takeover and the first distribution of special dividends in the Spanish PE industry is between 4.0509 and 4.4729 years. Consequently, although the sample highlights the high temporal volatility on the distribution of special dividends, all the statistics available are stressed on the fact that the first distribution takes place, on average, around four years after the LBO.

Once the descriptive analysis has been made, I present some generalizations about the PE industry in Spain carried out through two analyses. The first analysis tests whether the payment of special dividends in Spanish PE-backed companies is abnormal. This way, the research wants to prove that the distribution of special dividends in PE-backed companies is more common than what it seems. For that purpose I have taken a statement made by Harford & Kolasinski as a benchmark. The study made by Harford & Kolasinski (2014) showed that around 25% of the PE-backed portfolio companies have distributed special dividends to their respective PE funds. I have selected this benchmark because it is accepted and referenced by different authors when studying the PE business model. From the global database of 106 companies, I have obtained that 39,62% of PE-backed portfolio companies have distributed special dividends, which means that the benchmark is surpassed in such a considerable way. In this situation, a hypothesis test for the proportion is needed to be carried out in order to prove that the payment of special dividends in PE-backed portfolio companies is more common than the 25% rate.

First of all, and after assuming a level of significance of 5%, both null and alternative hypotheses are formulated:

- H_0 : 25% or less of the PE-backed portfolio companies distribute special dividends.
- H_1 : More than 25% of the PE-backed portfolio companies distribute special dividends.

The appropriate test statistic that we have used is:

$$\frac{\hat{P} - P}{\sqrt{\frac{P(1-P)}{n}}} \approx N(0,1) \quad Z_{OBS} = \frac{0.3962 - 0.25}{\sqrt{\frac{0.3962 * (1 - 0.3962)}{106}}} = 3.0775$$

While the decision value is the following:

$$Z_{\alpha} = Z_{0.05} = 1.645$$

Therefore, as $Z_{OBS} = 3.0775 > Z_{0.05} = 1.645$

We reject H_0 with a 5% level of significance

Consequently, at a 5% level of significance there is enough evidence supporting the fact that more than the 25% of the Spanish PE-backed portfolio companies distribute special dividends. Thus, in Spain, a revision of the 25% rate stated by Harford & Kolasinski (2014) may be necessary, as the distribution of special dividends in PE-backed portfolio companies might be more common than initially thought.

The final analysis consists of testing the relationship between special dividends and bankruptcy, which is the most serious consequence on the portfolio company's financial condition. For that purpose, I estimate the following multivariate logistic regression model.

$$\text{Bankruptcy (Yes, No)} = \alpha + \beta_1 * \text{Special dividend (Yes, No)} + \beta_2 * \text{Net income/Total assets} + \beta_3 * \text{Total liabilities/Total assets} + \beta_4 * \text{Current assets/Current liabilities}$$

A logistic regression model is used because the dependent variable is binary. The dependent variable is "bankruptcy" and the independent variable of interest is "special dividend". They are both binary variables with two values: 0 (no) and 1 (yes). The objective of the logistic regression is to analyse the statistical significance of the "special dividend" variable on the bankruptcy of the portfolio companies. The model also includes three control variables in order to make an accurate analysis about the statistical significance of the variable of interest. The three control variables are taken from the Zmijewski's bankruptcy prediction model. The Zmijewski's model is one of the most widely used by academics to quantify credit risk and evaluate a company's probability of bankruptcy (Sánchez et al, 2020). These variables are Net income/Total assets, Total liabilities/Total assets and Current assets/Current liabilities. In the cases in which the PE-backed companies of the sample distribute special dividends, these ratios are measured in the financial year when the distribution has taken place. In the cases in which the PE-backed companies do not distribute special dividends, these ratios are measured in the first financial year after the LBO has taken place.

To run the logistic regression, data for the 106 companies in the sample has been introduced into the *Gretl* statistical package. The results obtained are the following:

Table 1: Special dividend effect on bankrupt probability

	Bankruptcy		
	<i>Coefficient</i>	<i>Z Statistic</i>	<i>P-value</i>
Special dividends	0,459424	1,096	0,273
Net income / Total assets	-0,431718	-0,5028	0,6151
Total liabilities / Total assets	-0,758112	-0,9627	0,3357
Current assets / Current liabilities	0,4110681	1,684	0,0921*
Constant	-0,342682	-0,5136	0,6076
R-square	0,034986		
Number of observations	106		

Regression coefficients and relevant statistical measures are reported. *, ** and *** indicate that coefficients are significantly different from zero at the 10, 5 and 1 per cent levels, respectively.

Source: Gretl.

Table 1 shows the results of the logistic regression of special dividends on bankruptcy. The p-value of the special dividend variable (p-value = 0.273) is higher than 0.05, so it can be assumed that the distribution of special dividends does not have statistical significance on the subsequent bankruptcy of PE-backed portfolio companies. This result, however, may be obvious if I take into account the data obtained from descriptive statistics, where an important number of PE-backed portfolio companies that did not pay special dividends (26 out of 64) also ended up in bankruptcy. It seems then that portfolio companies' bankruptcy is unfortunately a common consequence of the different practices carried out within the PE industry, being not only a result of the distribution of special dividends. The substantial increase in the portfolio company's debt caused by the LBO itself, together with the subsequent exhaustive cost-reduction policies, explains many of the bankruptcy cases within the PE industry. Some of these bankrupted portfolio companies might have been already crippled by different reasons other than the payment of special dividends, so the effect of such distribution on the following bankruptcy process may not be significant enough. What could be, then, the actual effect of special dividends on bankruptcy? Could it be studied in greater detail?

This greater detail might be achieved if I consider that firms that pay special dividends should be, at least before the payment, in a solvent situation that backs up the payment. In other words, the effect of these other counter-productive practices on the regression might be better controlled if I exclude from the analysis the PE-backed portfolio companies that were already facing problems of operational effectiveness. Following this criteria, I run the regression with two separate groups. One group includes the PE-backed portfolio companies with a positive net income on the year of interest, while the other group includes the PE-backed portfolio companies with a negative net income on the year of interest. In the cases in which the PE-backed companies of the sample distribute special dividends, net income is measured in the financial year when the distribution has taken place. In the cases in which the PE-backed companies do not distribute special dividends, net income is measured in the first financial year after the LBO has taken place. This allows to differentiate between the companies that have already some negative indicators that may condition their subsequent bankruptcy and the companies that do not have such negative indicators. With this separation, the statistical significance of distributing special dividends may vary a lot between both groups. In this situation, I have two multivariate logistic regression models.

$Bankruptcy (Yes, No) = \alpha + \beta_1 * Special\ dividend (Yes, No) + \beta_2 * Net\ income(+)/Total\ assets + \beta_3 * Total\ liabilities/Total\ assets + \beta_4 * Current\ assets/Current\ liabilities$

$Bankruptcy (Yes, No) = \alpha + \beta_1 * Special\ dividend (Yes, No) + \beta_2 * Net\ income(-)/Total\ assets + \beta_3 * Total\ liabilities/Total\ assets + \beta_4 * Current\ assets/Current\ liabilities$

To run the logistic regression, data for the 46 companies in the sample with positive net income has been introduced into the *Gretl* statistical package. Then, the same regression has been carried out with the data from the 60 companies in the sample with negative net income. The results obtained are the following:

Table 2: Special dividend effect on bankrupt probability depending on net income

	Bankruptcy	
	Positive net income	Negative net income
	<i>Coefficient (p-value)</i>	<i>Coefficient (p-value)</i>
Special dividends	1,4319 (0,0337**)	-0,1788 (0,7658)
Net income / Total assets	3,3022 (0,7371)	-0,3333 (0,7387)
Total liabilities / Total assets	1,5824 (0,4737)	-0,8880 (0,3496)
Current assets / Current liabilities	-0,3663 (0,5785)	0,6121 (0,0661*)
Constant	-2,0997 (0,2868)	0,0051 (0,9949)
R-square	0,096207	0,068259
Number of observations	46	60

Regression coefficients and relevant statistical measures are reported. *, ** and *** indicate that coefficients are significantly different from zero at the 10, 5 and 1 per cent levels, respectively.

Source: *Gretl*.

Table 2 presents the results of these two separately estimated regressions. The first column shows the coefficients and the p-values for the independent variables in the 46 cases where the net income is positive. The second column shows the coefficients and the p-values for the independent variables in the 60 cases where the net income is negative.

For the regression of the first column, the p-value of the special dividend variable (p-value = 0.0337) is lower than 0.05, so it can be assumed that the distribution of special dividends has statistical significance in the bankruptcy of PE-backed portfolio companies when there is not any distortion from previous negative data. In other words, distributing special dividends has a substantial effect on the subsequent bankruptcy of portfolio companies when they do not have a previous negative indicator that might be otherwise justifying bankruptcy. It is, therefore, when the portfolio company enjoys a relatively well-balanced situation, that the distribution of special dividends triggers bankruptcy.

For the regression of the second column, the p-value of the special dividend variable (p-value = 0.7658) is higher than 0.05, so it can be assumed that the distribution of special dividends does not have statistical significance in the subsequent bankruptcy of PE-backed portfolio companies when there is a distortion from previous negative data. In other words, distributing special dividends does not have a substantial effect on the subsequent bankruptcy of portfolio companies when they have previous negative signals that may entail bankruptcy anyway.

Our results suggest that PE firms would be engaging in many practices (not only special dividends) that may compromise the long-term viability for the portfolio company. When these practices compromise the operational effectiveness of the portfolio company, the impact of distributing special dividends is not significant enough to attribute them the blame of the bankruptcy. However, when the company has not been previously deteriorated through other practices that generate losses, the impact of distributing special dividends is considerable enough to have a significant effect on the subsequent bankruptcy of the portfolio company.

4.4. Summary of the empirical research

The descriptive analysis of the empirical research has provided us with some insights that I would like to highlight.

- a) Article 273 of the Spanish 1/2010 Corporate Enterprises Act does not protect portfolio companies effectively against the distribution of special dividends. In fact, from the sample, basically every 3 out of 4 bankrupted Spanish PE-backed portfolio companies went bankrupt even though complying with Spanish corporate law. In other words, the usefulness of article 273 is being questioned. A legal reform of the Spanish corporate law might be necessary in order make a more restrictive regulation on this issue. The percentage of portfolio companies that comply with the law but end up in bankruptcy is not acceptable for a modern society where the rights of stakeholders are supposed to be respected.
- b) According to the sample, a very common way that GPs use to obtain the necessary cash to distribute special dividends is through dividend recapitalizations, issuing additional debt. Once the necessary cash is obtained, a substantial reduction of the equity's safety cushion is carried out to justify the distribution. These practices result in a common pattern used

by Spanish PE-backed portfolio companies, by which the company's liabilities increase considerably (to obtain the necessary cash) and subsequently the equity's safety cushion suffers a substantial decrease (to distribute the previously obtained cash).

- c) According to the sample, the average number of years between the takeover and the first distribution of special dividends in the Spanish PE industry is around four years, but the standard deviation of this distribution is more than two years. Therefore, we can assume that there is a high volatility on the distribution of special dividends, as some companies distribute them early after the takeover and others are more focused on carrying out cost-reduction policies as soon as possible. Anyway, the proposal to solve this problem is always the same: a more restrictive legislation is needed to stop GPs from carrying out these questionable practices that damage the portfolio company's long-term viability.

I have also evidenced that the percentage of Spanish PE-backed portfolio companies that distribute special dividends is statistically significant. I have taken Harford & Kolasinski (2014) as a benchmark of a high level of special dividends' distribution among PE-backed portfolio companies. The research has shown that the percentage of portfolio companies that distribute special dividends is significantly higher in my sample of Spanish PE-backed companies than the 25% found by Harford & Kolasinski for the US case. Consequently, if this practice is more common in Spain than in the US, Spanish authorities should reconsider our current legislation and claim for more restrictive measures in order to reduce these questionable practices.

Finally, I have run logistic regressions of special dividends on the bankruptcy of PE-backed portfolio companies. The reality of the Spanish case shows that almost half of the PE-backed portfolio companies ended up bankrupted. Therefore, the relationship between distribution of special dividends and bankruptcy is not significant enough because the percentage of PE-backed companies that end up bankrupted is too high that no matter whether they distribute special dividends or not. However, separate regressions have allowed me to identify a common pattern in the impact of special dividends on bankruptcy. When the portfolio company has previous difficulties – caused by the LBO itself, by the cost reduction policies or by other means – the distribution of special dividends does not directly cause bankruptcy, as the interconnection of all these causes

may be the truly source of bankruptcy. However, when there is not such an interconnection of negative causes, and the only alteration is the distribution of special dividends, it can be affirmed that such distribution is a direct cause on the subsequent bankruptcy of the portfolio company. Therefore, the main danger of special dividends does not come to portfolio companies that are struggling against financial difficulties. Instead, the danger comes to stable portfolio companies to which the distribution of special dividends is the detonator that triggers the bankruptcy process. In this sense, the regulation of special dividends' distribution should not be only focused on protecting companies that already have difficulties, but also well-balanced companies should be protected against this imperturbable detonator.

5. CONCLUSIONS

In this project I have studied the special dividends paid by PE-backed portfolio companies to their controlling funds. Special dividends have been defined as one-time cash distributions that are not as regular as ordinary dividends and that are not usually based on the net income. This study has also drawn an irrefutable conclusion about the PE industry: special dividends cause substantial problems to PE-backed portfolio companies. The distribution of special dividends creates an interconnection of problems that erode the operational effectiveness of the portfolio company. The eagerness that the GPs show to recover their investment as soon as possible – together with the cost reduction policies used to increase efficiency – cripples the viability of the company in the long term. Often times, once the PE fund has exited the company, what the new buyer finds out has little to do with the target company that existed before the LBO. This unpunished extraction of value exercised by the GPs breaks the rules of healthy competition that support the principles of the current market economy. And, as always, the main victims of this “game” are the rest of stakeholders of the portfolio company, such as employees, suppliers, customers or the society in general. Where is the fairness of the market economy when an employee that earns 1,000€/month loses his job while at the same time the General Partners receive millionaire dividends? Where is the fairness of the market economy when a respectable and well-known company goes bankrupt after only a few years of a more than questionable PE management? The lack of a rationale answer to these questions allows us to categorize Private Equity as an imperfection of the current market economy.

Responsibility is well located. On the one hand, the GPs, who are capable of anything with the only aim of earning more and more money, without assuming the corresponding responsibilities. The distribution of special dividends makes the GPs richer and richer, but at the expense of everybody else in the portfolio company. On the other hand, regulation or, better said, the lack of it. The Spanish corporate regulation – as well as the EU and US regulation – does not actually protect properly neither the portfolio company nor its stakeholders against the payment of dividends. In fact, the Spanish and EU regulations are based on the impairment of capital test approach, which is focused on preserving the social capital. As I have shown in the empirical research, complying with a regulation that is based on the social capital is not an efficient solution. It is not difficult to significantly damage equity without breaking the law. Consequently, the impairment of capital test approach has proven to be useless. It remains to be seen whether the EU's Alternative Investment Fund Manager Directive has been useful or not. However, having seen the easiness by which special dividends are distributed in the PE industry, no matter how many time has passed since the LBO, the expectations are not too encouraging. The only hope of improvement comes from the US legislation, where a new approach based on the balance sheet insolvency test and on the cash flow insolvency test is more focused on whether the company will be able to pay its liabilities on time once the dividend distribution has been made. This new approach, if implemented in the EU, may overcome the problems of the current legislation and restrict GPs when distributing special dividends.

My empirical research has also suggested that these terrible consequences for portfolio companies are not only the result of distributing special dividends. The problem extends to other practices of the Private Equity business model. Distributing special dividends is probably one of the most damaging techniques used by the PE industry to destroy value – especially if the portfolio company is in a relatively stable situation – but it is not the unique. In fact, reality shows that Private Equity has too many drawbacks so it is initially inconceivable how this model of business has been so extremely successful. Hopefully, the repercussion of PE infamous cases – such as Southeastern Grocers – and the creation of new platforms of PE victims – such as the Private Equity Stakeholder Project – may allow the society to open their eyes and be extremely critical with this model of business. The worse the fame Private Equity has, the more difficult for them to carry out investments and distribute special dividends.

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7. ANNEXES

Annex 1: Global database extracted from a sample of 106 companies

<u>Company</u>	<u>Special dividends</u>	<u>Bankruptcy</u>	<u>Year LBO</u>
Aluminio Catalán	Yes	Yes	2002
Chic Corporation Worldwide	Yes	Yes	2007
Anguilas Aguinaga	Yes	No	2006
Arsys Internet	Yes	No	2008
Aseguramiento Técnico de Calidad	Yes	No	2005
Chiqui Park	Yes	Yes	2000
Deltalab	Yes	No	2009
Dinak	Yes	No	2005
Grupo Electro Stocks	Yes	No	2007
Muñecas de Onil	Yes	Yes	2002
Guzmán Gastronomía	Yes	No	2005
Futura International Airways	Yes	Yes	2002
Gesinar Servicios Inmobiliarios	Yes	Yes	2003
Grupo Empresarial Palacios Alimentación	Yes	No	2009
Iberchem	Yes	No	2007
Krafft	Yes	Yes	1998
Ros Fotocolor	Yes	Yes	2001
Memora Servicios Funerarios	Yes	No	2008

Núcleo de Comunicaciones y Control	Yes	No	2006
Bimbo Donuts Iberia	Yes	No	2005
Port Aventura Entertainment	Yes	No	2009
Premo	Yes	Yes	2007
Restauravia Food	Yes	No	2006
Telecable de Asturias	Yes	Yes	2011
Forte Hormigones Tecnológicos	Yes	Yes	2006
Galletas Artiach	Yes	No	2008
Festa Moda	Yes	Yes	2006
Emfasis Billing & Marketing Services	Yes	Yes	2005
Novolux Lighting	Yes	No	2005
Quiron Hospitales	Yes	Yes	2007
Comess Group de Restauración	Yes	No	2007
Grupo Navec Servicios Industriales	Yes	No	2006
Grupo El Árbol Distribución y Supermercados	Yes	No	2009
Idcsalud	Yes	Yes	2006
Contenur	Yes	Yes	1998
Hune Maquinaria	Yes	Yes	2006
Hitecsa Aire Acondicionado	Yes	Yes	2001
Noa Brands Europe	Yes	No	2009
Sintax Logística	Yes	Yes	1996
Grupo Mobiliario del Urola	Yes	Yes	2005
Pelican Rouge Coffee Solutions	Yes	Yes	2011
Taller Contemporáneo	Yes	Yes	2011
Acens Technologies SL	No	No	2007
Alcad SL	No	Yes	2007
Alco Grupo Empresarial SL	No	Yes	2006
Araven SL	No	No	2007
Nekicesa Packaging SL	No	No	2006
Aurgi SL	No	Yes	2004
Avanza Spain SL	No	No	2007
Bermarmol SL	No	Yes	1997
Colegios Laude SLU	No	No	2006
Crawford Combrusa SL	No	Yes	2000
Grupo Conservas Garavilla SL	No	No	2010
Construcciones Accesorios Turbo-Paconsa SA	No	Yes	2003
Astilleros Menorquín Yatchs SL	No	Yes	2005
Grupo Editorial El Derecho y Quantor SL	No	Yes	2006
Acciona Eólica Cesa SL	No	No	2004
Servipack SA	No	Yes	2000
Tendam Retail SA	No	No	2005
Cunext Copper Industries SL	No	No	2004

Dorna Sports SL	No	No	2006
Darty Hispania SA	No	Yes	2003
Faeton Yatchs SL	No	No	2005
General de Bombeo de Hormigón SL	No	No	2005
Gescobro Collection Services SL	No	No	2010
Eptisa Servicios de Ingeniería SL	No	No	2007
Grupo Euro 56 SL	No	Yes	2005
Eurovalls Materiales para la Construcción SL	No	Yes	2003
Grupo Itevelesa SL	No	No	2006
Golden Desarrollos SL	No	No	2001
Ibérica de Diagnóstico y Cirugía SL	No	Yes	1998
Grupo FSM Vertispania SL	No	No	2001
Complementos Innovación y Moda SL	No	Yes	2006
Infraestructuras de Alta Tensión SA	No	Yes	2002
Lekue SA	No	No	2005
Lizarran Tabernas Selectas SL	No	Yes	2005
Majorica SAU	No	Yes	1998
Marie Claire SA	No	No	1998
Real Musical SA	No	No	2001
TG Plus Transcamergomez SA	No	Yes	2003
Nueva Terrain SL	No	No	2005
Freigel Foodsolutions SAU	No	No	2004
Proyteca Security SL	No	Yes	2009
Recoletos Grupo de Comunicación SA	No	Yes	2001
Sedal SLU	No	No	2002
Segur Ibérica SA	No	Yes	1999
Svenson SLU	No	No	2002
APM Terminals Barcelona SL	No	No	2000
Pressto Enterprises SL	No	No	2008
Transmol Logística SL	No	No	2003
Automotive Modular Systems SL	No	Yes	2002
Isolux SA	No	Yes	1999
Ibersegur Systems SL	No	Yes	2003
SDI Media Iberia SL	No	No	2006
Sammic SL	No	Yes	2001
Grupo Tecnipublicaciones SL	No	Yes	2004
Grupo de Bodegas Vinartis SA	No	No	2003
Productos Naturales de la Vega SL	No	No	2011
Gamo Outdoor SL	No	No	2007
Grupo Garnica Plywood SL	No	No	2006
Punt Mobles XXI SL	No	No	2011
Fabricas Agrupadas de Muñecas de Onil SAU	No	No	2005

Siemens Gamesa Renewable Energy SL	No	No	2008
Came Parkare Group SL	No	No	2007
De Heus Nutrición Animal SAU	No	No	2007
Douglas Spain SA	No	No	2007

Source: Own elaboration

Annex 2: Separate database formed by the 42 companies from the sample that distributed special dividends

<u>Company</u>	<u>Special dividends</u>	<u>Bankruptcy</u>	<u>Year LBO</u>	<u>Year first payment of dividends</u>	<u>Equity's safety cushion account</u>	<u>% reduction of equity</u>	<u>Social capital ≤ Equity</u>	<u>Increase of liabilities</u>
Aluminio Catalán	Yes	Yes	2002	2007	Prima de emisión	13,83%	Yes	Yes
Chic Corporation Worldwide	Yes	Yes	2007	2009	Otras reservas	34,85%	Yes	Yes
Anguilas Aguinaga	Yes	No	2006	2015	Otras reservas	48,90%	Yes	Yes
Arsys Internet	Yes	No	2008	2013	Prima de emisión	18,29%	Yes	Yes
Aseguramiento Técnico de Calidad	Yes	No	2005	2009	Prima de emisión	64,00%	Yes	Yes
Chiqui Park	Yes	Yes	2000	2006	Resultados negativos	64,65%	No	Yes
Detalab	Yes	No	2009	2013	Otras reservas	33,79%	Yes	Yes
Dinak	Yes	No	2005	2011	Otras reservas	50,55%	Yes	Yes
Grupo Electro Stocks	Yes	No	2007	2012	Resultados negativos	34,72%	Yes	No
Muñecas de Onil	Yes	Yes	2002	2005	Otras reservas	39,17%	Yes	Yes
Guzmán Gastronomía	Yes	No	2005	2011	Otras reservas	56,09%	Yes	Yes
Futura International Airways	Yes	Yes	2002	2007	Otras reservas	73,92%	Yes	Yes
Gesinar Servicios Inmobiliarios	Yes	Yes	2003	2005	Resultados negativos	34,65%	Yes	Yes
Grupo Empresarial Palacios Alimentación	Yes	No	2009	2015	Prima de emisión	45,48%	Yes	Yes
Iberchem	Yes	No	2007	2013	Prima de emisión	51,32%	Yes	Yes
Krafft	Yes	Yes	1998	2002	Prima de emisión	18,84%	Yes	Yes
Ros Fotocolor	Yes	Yes	2001	2004	Otras reservas	45,55%	Yes	Yes
Memora Servicios Funerarios	Yes	No	2008	2012	Resultados negativos	516,86%	No	Yes
Núcleo de Comunicaciones y Control	Yes	No	2006	2009	Resultados negativos	98,36%	No	Yes
Bimbo Donuts Iberia	Yes	No	2005	2006	Prima de emisión	156,57%	No	Yes
Port Aventura Entertainment	Yes	No	2009	2011	Prima de emisión	47,07%	Yes	Yes
Premo	Yes	Yes	2007	2019	Resultados negativos	30,24%	Yes	Yes
Restauravia Food	Yes	No	2006	2011	Otras reservas	19,78%	Yes	Yes
Telecable de Asturias	Yes	Yes	2011	2013	Otras reservas	67,15%	Yes	Yes
Forte Hormigones Tecnológicos	Yes	Yes	2006	2007	Resultados negativos	24,38%	Yes	Yes
Galletas Artiach	Yes	No	2008	2012	Prima de emisión	22,07%	Yes	No
Festa Moda	Yes	Yes	2006	2011	Otras reservas	80,35%	No	Yes
Emfasis Billing & Marketing Services	Yes	Yes	2005	2007	Prima de emisión	65,58%	Yes	No

Novolux Lighting	Yes	No	2005	2011	Resultados negativos	75,43%	Yes	No
Quiron Hospitales	Yes	Yes	2007	2009	Resultados negativos	72,50%	No	Yes
Comess Group de Restauración	Yes	No	2007	2011	Resultados negativos	28,14%	No	Yes
Grupo Navec Servicios Industriales	Yes	No	2006	2012	Otras reservas	7,23%	Yes	Yes
Grupo El Árbol Distribución y Supermercados	Yes	No	2009	2014	Resultados negativos	63,11%	No	Yes
Idcsalud	Yes	Yes	2006	2008	Otras reservas	21,24%	No	Yes
Contenur	Yes	Yes	1998	2003	Resultados negativos	6,91%	Yes	Yes
Hune Maquinaria	Yes	Yes	2006	2007	Otras reservas	24,16%	Yes	Yes
Hitecsa Aire Acondicionado	Yes	Yes	2001	2010			Yes	
Noa Brands Europe	Yes	No	2009	2009	Resultados negativos	29,08%	No	Yes
Sintax Logística	Yes	Yes	1996	2002	Otras reservas	37,16%	Yes	Yes
Grupo Mobiliario del Urola	Yes	Yes	2005	2007	Otras reservas	9,35%	Yes	No
Pelican Rouge Coffee Solutions	Yes	Yes	2011	2017	Otras reservas	31,92%	Yes	No
Taller Contemporáneo	Yes	Yes	2011	2014	Resultados negativos	3699,68%	No	Yes

Source: Own elaboration

Annex 3: Database formed by the variables and the ratios needed to carry out the logistic regressions

<u>BANKRU</u> <u>PTCY</u>	<u>SPECIAL</u> <u>DIVIDEND</u>	<u>Net</u> <u>Income/Total</u> <u>Assets</u>	<u>Total</u> <u>liabilities/Total</u> <u>Assets</u>	<u>Current</u> <u>Assets/Current</u> <u>liabilities</u>
Yes	Yes	0,019919205	0,608681954	1,577426332
Yes	Yes	0,005432238	0,940554027	0,940471105
No	Yes	0,03918308	0,789933318	1,255895792
No	Yes	-0,035030981	0,481198553	0,745357824
No	Yes	-0,00072128	0,923454208	1,143609023
Yes	Yes	-0,1861762	2,091057451	4,47333636
No	Yes	0,057142713	0,60762499	1,365705893
No	Yes	0,015759496	0,896575057	0,830954978
No	Yes	-0,01874194	0,766190635	2,549840526
Yes	Yes	-0,027839859	0,796688171	1,081901089
No	Yes	0,007305392	0,797830028	1,084182005
Yes	Yes	0,077275516	0,933428786	0,959689687
Yes	Yes	0,143388536	0,965364159	0,871136624

No	Yes	-0,012226074	0,874704339	1,591026284
No	Yes	0,080212107	0,741600092	1,480001095
Yes	Yes	0,072073499	0,646243826	1,532671611
Yes	Yes	-0,076555192	0,508677104	1,748527673
No	Yes	-0,045202109	0,95313459	1,481246995
No	Yes	-0,02931886	0,793677126	1,069818784
No	Yes	-0,057395562	1,053762574	0,29833113
No	Yes	0,061912906	0,807678816	0,793187028
Yes	Yes	0,008254614	0,691244883	2,514787089
No	Yes	0,025373061	0,589550353	0,816179934
Yes	Yes	-0,014014277	0,743130508	0,427165431
Yes	Yes	0,000579021	0,941380231	0,922871239
No	Yes	0,16944135	0,255148814	0,104508662
Yes	Yes	-0,119597201	1,196189631	2,003840248
Yes	Yes	-0,051073621	0,958038868	0,904423984
No	Yes	-0,069703393	0,968379047	2,940129701
No	Yes	-0,02931714	0,793673454	1,069822062
No	Yes	-0,049944156	0,834531344	1,43676815
No	Yes	0,002269921	0,635837941	1,223238231
No	Yes	-0,350882469	1,659026819	0,305269055
Yes	Yes	-0,002382496	1,049764785	1,107097445
Yes	Yes	0,002936592	0,738259279	1,13227817
Yes	Yes	0,090306332	0,613846628	1,90455416
Yes	Yes	-0,056210022	1,158403255	2,085664713
No	Yes	-2,509903253	2,786163463	1,281794198
Yes	Yes	0,007913378	0,860898977	1,219515025
Yes	Yes	0,063237314	0,534611049	1,308125364
Yes	Yes	-0,064707901	0,44479989	0,485071153
Yes	Yes	-0,572305648	1,608078325	0,571905528

No	No	0,041289584	0,565198558	0,632626092
Yes	No	-0,034532238	0,643482237	2,290912432
Yes	No	-0,001258377	0,832723877	1,216541239
No	No	-0,012484349	0,888943045	1,266880022
No	No	-0,053728053	0,76714676	0,016209168
Yes	No	-0,029325764	0,630426976	0,761054464
No	No	-0,038805297	1,01209559	0,362804439
Yes	No	0,074418747	0,841029222	1,350003575
No	No	-0,104757467	1,037865058	0,36800682
Yes	No	-0,011673535	0,927858901	1,49877407
No	No	0,017274146	0,69134161	1,227911272
Yes	No	-0,054074611	0,930451252	1,391948805
Yes	No	-0,019605961	0,933034755	0,330088467
Yes	No	-0,001509467	0,574041599	1,619178459
No	No	-0,021060557	0,500596504	1,247650779
Yes	No	-0,532449184	0,521602406	0,345011424
No	No	0,038726767	0,818684793	0,898178808
No	No	0,008027215	0,945185292	0,995997542
No	No	-0,029578068	0,905809251	3,225832709
Yes	No	0,049247613	0,874002108	0,922458712
No	No	-0,065239399	0,942967776	1,171480215
No	No	0,032544686	0,969661779	1,172477392
No	No	-0,051323529	0,751691176	1,013398839
No	No	0,026229756	0,810619004	1,297111307
Yes	No	-0,022146498	0,786082951	0,834809735
Yes	No	0,061136215	0,489828681	0,004544525
No	No	-0,05740799	0,995355109	0,085168055
No	No	0,033989559	0,908284521	1,256302568
Yes	No	-0,006615226	0,929645423	1,455576504

No	No	-0,040702915	0,60281496	0,820362083
Yes	No	-1,212460494	0,330079157	2,30019924
Yes	No	-0,001710444	0,926088926	1,708599911
No	No	-0,075234927	0,656254404	1,140177077
Yes	No	0,021211424	0,509777117	0,636955215
Yes	No	-0,004634377	0,927456195	1,081470587
No	No	0,006832519	0,804706218	2,133959065
No	No	-0,259978041	0,714485699	1,203408029
Yes	No	-0,074663953	0,953900038	1,254005379
No	No	-0,019819267	0,706845832	0,270362998
No	No	0,000459662	0,662670677	1,080721463
Yes	No	-0,051175977	0,559995415	7,438921928
Yes	No	-0,259978041	0,714485699	1,203408029
No	No	0,047892364	0,467316695	2,404450543
Yes	No	-0,006347897	0,886331201	1,263117419
No	No	0,041725465	0,481315121	0,179061464
No	No	-0,006029758	0,866375084	0,953670389
No	No	-0,11520323	1,004983592	1,034011103
No	No	0,070987388	0,73182223	1,076771477
Yes	No	-0,035526753	0,531700456	4,60784381
Yes	No	0,035291955	0,801145763	0,925911773
Yes	No	-0,017948966	0,188568505	1,774255532
No	No	0,000579021	0,941380231	0,922871239
Yes	No	0,009928007	0,823008593	0,341585337
Yes	No	-0,123801221	0,399193548	0,600757576
No	No	0,004772675	0,654193736	1,156645404
No	No	-0,026664756	0,505877915	0,020209213
No	No	0,030278735	0,934333752	2,028210029
No	No	0,041229001	0,745278703	0,789988302

No	No	-0,263157895	0,800362976	0,77324263
No	No	-0,03275559	0,972019541	1,149362493
No	No	0,022898148	0,791239783	2,345215843
No	No	0,050250491	0,696273828	1,2018465
No	No	0,050250491	0,696273828	1,2018465
No	No	0,019820064	0,859810956	1,502006192

Source: Own elaboration