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Buyer should beware in structured product deals

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When a public company buys a closely held business, the seller often gets a substantial stake in the stock of the public company.

This can be beneficial taxwise because taxes may not have to be paid until shares of the public company are sold. The seller therefore trades the illiquid, closely held company to a public company, receiving the benefit of the liquidity (common stock) of the acquirer. However, the seller still has a concentrated position in a single stock.

The risks of a concentrated position, whether in a closely held or publicly traded company, are substantial. One benefit of holding shares of a public company may be the ability to hedge that position, but buyers should be cautious. A seemingly sound structure and strategy may be a commodity in the real world, and the prices that are charged and the commissions levied by brokers and banks can vary significantly.

A prepaid variable forward contract (PVF) is one such strategy. A PVF is typically a guarantee of limited downside risk in a stock position, with some participation in the upside, and a substantial amount of cash is paid up front to that closely held stock owner.

If structured properly, a taxable event may not be created until the end of the term (it can be for many years), and the stockholder has significant liquidity to make other investments and diversify much of the risk that accompanies a single position. The structure can be very complicated from a tax point of view. Those involved should utilize legal advice.

Many banks and brokers will compete for the contract, and the terms will be comparable between most high-quality institutions. The problem is that commission rates vary hugely, and the client may never know it.

Case in point (some of the details have been changed to protect the identity of the investor, but general circumstances are accurate):

A business seller received $25 million in common stock from the sale of a business. His longtime securities broker presented a PVF to him. The stock would be hedged to limit all downside risk, would receive up to a 40 percent gain on the stock, receive the current dividend rate plus one-third of any dividend increase, and would have a $15 million loan against the $25 million wired to his bank account to invest in other areas, spend or leave in the account.

The term was five years, and at the end of the term, the client would repay the loan with the shares needed to cover the loan. The client could receive substantially more at the end of the contract, a long-term capital gain would be triggered and Uncle Sam would finally get his due.

The broker scoured the universe for the best deal for the client, going only to the best banks, and settled on an AAA, high-rated institution to guarantee the transaction.

Not disclosed to the client was that the broker carved out a piece of the deal for himself and was receiving a healthy $1 million in commission. Luckily for the client, its CPA wanted objective and independent advice on the structure and the deal, and asked another company to re-bid the contract.

Many of the same banks were involved in the new bidding process. Not surprisingly, the client was able to put well over $1 million more into his pocket.

There are many cases like this, especially when the broker/advisor has a captive client.

Relationships are always important with your advisor, but be careful to not get too cozy. Commissions corrupt advice, and at times, it's difficult to know when a commission is paid, let alone its amount.

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