

Rollover equity looks simple at first glance: the seller keeps a slice of ownership alongside the buyer instead of cashing out completely. In practice, it shapes price, governance, tax outcomes, and the risk profile for both sides. If you are Buying a Business, especially in the lower middle market where leverage and management continuity matter, you will see rollover equity in most competitive deals. Get it [*Buy a Business*](#) right and you align incentives, protect downside, and open doors to better financing. Get it wrong and you inherit a resentful partner, mismatched expectations, and a cap table that becomes an anchor.

I have sat through negotiations where a 20 percent rollover unlocked an extra turn of EBITDA in valuation because the lender took comfort from the seller’s ongoing skin in the game. I have also had a seller call six months post-close, furious that distributions were being retained for growth instead of paid out like clockwork, because the operating agreement did not set expectations. Both results flowed from the same tool, used with different levels of care.

What rollover equity actually is

Rollover equity is the portion of the seller’s sale proceeds that is reinvested into the buyer’s acquiring entity. The reinvestment can be in the form of common equity, preferred equity, or a mix. The key idea is continuity: the seller-operator or selling shareholders carry an economic interest into the next chapter. Lenders, private equity funds, and searchers often encourage or even require this arrangement.

A typical structure in a \$10 million enterprise value deal might look like this: the buyer funds \$4 million in equity, the senior lender provides \$4.5 million in debt, and the seller rolls \$1.5 million (15 percent of the capital stack), often credited against the purchase price. The exact percentages swing widely. I have seen rollovers as low as 5 percent when the seller is largely exiting, and as high as 40 percent when the seller wants a “second bite” and remains deeply involved.

Rollover equity is not the same as an earnout. An earnout ties contingent consideration to future performance metrics, usually over 12 to 36 months. Rollover equity is ownership. It has governance rights, distributions, and exit participation. You can have both in one deal, but they solve different problems.

Why buyers push for a rollover

The buyer’s logic is straightforward. First, alignment. If the seller remains invested, they are less likely to sandbag during transition or gloss over fragile customer relationships. Second, financing. Banks and mezzanine lenders like to see sellers reinvest, because it lowers perceived risk. Third, value capture. In a company with clear growth levers, the rollover persuades a seller to accept a lower cash price up front in exchange for participation in the upside.

There is a subtler benefit. A rollover filters for confidence. If the seller refuses to roll a meaningful amount despite saying the business will easily double, that gap tells you something. I once had a founder touring a buyer through “obvious” expansion markets, then balk at a 10 percent roll. We slowed the process, dug into their customer concentration, and discovered heavy dependence on a single distributor facing its own problems. The rollover debate saved the buyer from overpaying.

Where it goes off the rails

Misaligned roles, unclear distribution policies, and sloppy tax planning do the damage. In lower middle market deals, governance documents are often an afterthought. Everyone is racing to close, and law firms paste in standard forms. Six months later, the seller, now a minority holder, expects quarterly dividends like clockwork, while the buyer is banking cash to fund a plant move. You can avoid most of this trouble by being explicit, early, and specific.

Another failure mode is papering a rollover in name only. If the seller’s instrument is a remote, non-participating preferred with a low cap, it will not feel like true alignment. Conversely, if the seller keeps full common equity rights with board control vetoes, you may have brought in a partner, not a passive minority investor. Each choice has trade-offs. What matters is consistency with the operating plan and the personalities around the table.

Instrument choice: common, preferred, or something in between

Common equity is simplest. The seller rolls into the same common class as the buyer, shares pro rata in distributions and exit proceeds, and usually gets minority protections. This works best when the seller will be active in the business and the buyer wants

clean alignment without a complex priority stack.

Preferred equity introduces a priority. The seller might receive a preferred return, a liquidation preference at exit, or cumulative dividends. I have used preferred when the seller steps back operationally but still wants steady yield, or where the buyer's model calls for reinvestment for several years. The preference compensates the seller for waiting.

Hybrid structures are common. You may grant the seller common with a modest "catch-up" at exit, or provide participating preferred with a capped multiple to prevent the seller from crowding out the buyer's upside. Be careful with cumulative preferred returns in heavily leveraged deals. They can grow into a thorn that distorts decision-making if operating cash is tight and the accrual compounds.

Warrants and profits interests appear in tax-sensitive contexts. For example, a seller who wants option-like upside without current income may take a profits interest in an LLC taxed as a partnership. The accounting and tax details matter here, and you need a CPA who lives in partnership tax to avoid nasty surprises.

Sizing the rollover: signaling and practicality

There is no universal "right" percentage. I look at three anchors: financing requirements, seller psychology, and business volatility.

- **Financing requirements:** Many senior lenders ask for a minimum seller rollover, often 5 to 15 percent of total consideration, as a condition. Mezzanine lenders may nudge that higher. If the debt service coverage is tight, a bigger rollover can grease the underwriting.
- **Seller psychology:** A founder selling after 25 years may be emotionally ready to move on. Pushing for a 30 percent rollover just to win points with the bank might backfire and sour the transition. A practical range for founder exits tends to be 10 to 20 percent if they remain for a handover year, more if they will keep running the business.
- **Business volatility:** If revenue rides big project wins or commodity swings, a larger rollover smooths the risk-sharing. In a recurring revenue software firm with stable churn, alignment can be achieved with less.

Note the optics: a 1 percent rollover reads like tokenism. A bank or investment committee will ask the question you do not want to answer: if the story is that strong, why is the seller not more invested?

Governance and decision rights: the hidden lever

The cleanest deals set bright lines before closing. Spell out which decisions require board or member consent, and who holds those consents. Budget approvals, capital expenditures over a threshold, new debt, related-party transactions, and changes to compensation for key executives are the usual suspects. If the seller will hold a board seat, define term, votes, and what happens if they miss meetings.

In one industrial services deal, we set a rolling capex threshold at 4 percent of revenue, with any overage needing both the CEO and one independent director to sign off. The seller had a seat but no unilateral veto. That balance let the company react fast to equipment failures while forcing discussion on large expansions. Without that clarity, a single new truck purchase might have turned into a weekly argument.

Distributions should be addressed just as explicitly. Many operating agreements reference "available cash," which invites argument. I prefer a defined waterfall: reserve targets for working capital, debt service, and a maintenance capex bucket, then a policy for distributions if the business exceeds those targets. If the thesis involves reinvesting for growth, write that into the plan so the seller does not expect near-term yield that is not coming.

Valuation dynamics: how the rollover affects price

Rollover equity can nudge valuation up or down. Sellers sometimes accept a slightly lower cash price to participate in a larger pie later. Buyers will sometimes stretch further on headline price if the seller agrees to roll and leave more value at risk. Lenders often price leverage more favorably when the seller rolls, which means lower interest costs and more flexibility. All of that feeds the final economics.

Be careful with optical math. If you value a company at 6x EBITDA, then ask the seller to roll 20 percent, you have not automatically “saved” 20 percent of the purchase price. You still owe the economic value, only part is paid later if and when there is a successful exit. The internal rate of return story can be excellent for both sides, but it is not free money.

I like to build two models for the investment committee. One model shows an all-cash purchase at a lower price. The second shows a higher price with a seller rollover and potentially richer debt terms. Side by side, you can test sensitivities: what happens if growth slips by 2 points, or if we exit a year later? Seeing those trade-offs prevents happy talk.

Tax considerations you cannot ignore

Tax cuts both ways. On the seller’s side, a properly structured rollover can be tax-deferred, at least for the rolled portion, if it qualifies as a continuation of investment under relevant sections of the tax code. Get this wrong and the seller might owe tax on value they did not actually receive in cash. That will wreck goodwill and, in the worst case, trigger litigation.

Entity choice looms large. If the buyer uses an LLC taxed as a partnership and invites the seller in as a member, you open the door to partnership allocations, K-1s, and potential self-employment tax on certain earnings. That may be fine, but the seller should know what they are walking into. In [Home page](#) a C-corp or S-corp environment, you will face different constraints, including S-corp eligibility and built-in gains issues. Cross-border sellers complicate the picture further.

On the buyer side, be mindful of basis. If you structure the deal as an asset purchase with a Section 338(h)(10) election or similar, you may step up the basis in assets, which helps depreciation and amortization. That can be valuable enough to justify a cleaner cash component and a smaller rollover. Coordination between M&A counsel and tax counsel is not optional here.

Employment, vesting, and the human side

Rollover equity comes with expectations. If the seller will stay on as CEO or in a commercial role, tie their role to clear goals and a realistic timeline. You can pair the rollover with a separate management incentive plan so new hires share upside too, which prevents resentment toward the legacy owner. If you expect the seller to step back within a year, design vesting or repurchase mechanics for their employment-linked equity to avoid paying full value for unfulfilled responsibilities.

I prefer simple repurchase rights pegged to fair market value, with a discount if the departure is for cause within a defined window. Complex clawbacks breed arguments. Always align the vesting and repurchase rules in the equity documents with the employment agreement. Buyers sometimes forget this and wind up with contradictory terms.

Rollover versus earnout: when to use which

An earnout solves for information asymmetry around near-term performance. For example, if a company just launched a product with an uncertain ramp, an earnout tied to 12-month revenue makes sense. Rollover equity aligns for the long arc. It gives the seller a stake in five-year decisions, not just the next quarter. Use earnouts to price fuzzy near-term outcomes. Use rollovers to keep the former owner mentally and financially in the boat.

There are times to avoid earnouts entirely, particularly in businesses where accounting judgments could skew metrics, or where integration will blur lines of responsibility. If you cannot write an earnout that both sides can measure without a referee, lean harder on rollover equity and governance instead.

Debt, covenants, and cash flow reality

If you are using debt, your lender’s covenants will set the tempo for distributions and growth spending. Marry that reality to the rollover agreement. I have seen sellers agree to a preferred return, then discover that the credit agreement blocks distributions until leverage drops below a certain threshold. The preference accrues, but the cash never moves. That can be acceptable if everyone understands it up front. If not, you have a bruised relationship.

Build a 24-month cash flow forecast that includes amortization, capex, taxes, and covenant headroom. Share it with the seller during negotiations to set expectations. When a seller sees that a fixed-charge coverage test leaves only thin air for distributions in year one, they start thinking like a continuing owner, which is exactly what you want.

Diligence points unique to rollovers

When a seller becomes your partner, you are marrying into their past. Scrub any outstanding legal exposures, tax audits, or environmental issues that might flow to the rollover entity. If the seller is contributing equity in kind rather than cash, confirm title and any transfer restrictions. In closely held companies, minority shareholder consent might be needed even if the majority is selling.

I look hard at any existing phantom equity, options, or profit-sharing plans. They can dilute the economics the seller thinks they are rolling. Address them in the purchase agreement so no one is surprised when the cap table gets rebuilt post-close.

How to explain rollover equity to a seller who has never done a deal

Most founder-sellers do not speak in waterfalls and prefs. Keep it concrete. Show a simple before-and-after with two or three scenarios: base case, downside, and upside. Put dollars next to each. If the base case shows their rolled \$1.5 million turning into \$3 million at a likely exit, while the downside still preserves a meaningful portion, the story becomes real. Be transparent about fees and expenses that hit the cap table so they do not assume every dollar of exit value lands in their pocket.

Be candid about the time horizon. If you run a hold strategy of five to seven years, say so. If you intend to recap sooner once leverage comes down, outline how that works and where the seller sits in the priority stack. Surprises poison relationships far faster than a tough truth in diligence.

A case vignette: alignment created and avoided pitfalls

A regional HVAC service company with \$3 million in EBITDA came to market at an 6.5x ask. The business had sticky maintenance contracts and a founder who wanted to exit operations within 18 months. We proposed 6.0x total value with a 15 percent rollover by the founder, common equity with standard minority protections, and a distribution policy keyed to a cash balance target and fixed-charge coverage above 1.5x.

The lender liked the rollover and improved pricing by 50 basis points. The founder initially pushed for a preferred return, but when we walked through the covenants, he saw that cash distributions would be constrained in year one. We kept it as common, and instead gave him a board observer right and a specific post-close bonus for completing the leadership transition. The operating agreement spelled out capital call procedures, budget thresholds, and a buyback mechanism at fair market value if he left early for any reason other than cause. Because we dealt with these items up front, post-close life was calm. Two years later, the company added a second branch and refinanced, returning a small dividend to all owners without friction.

Common mistakes buyers make, and how to avoid them

- Treating the rollover as a discount lever rather than an alignment tool. If the seller feels squeezed, they will behave like a reluctant passenger, not a partner.
- Overcomplicating the capital structure. Simplicity wins unless a specific risk requires a preference or cap.
- Ignoring tax and entity mechanics until the eleventh hour. Early tax planning often unlocks cleaner, friendlier terms.
- Leaving distribution policy vague. Ambiguity breeds disputes when cash gets tight or opportunities arise.
- Neglecting the handoff plan. If the seller is staying, define roles, timelines, and what success looks like.

Integrating rollover equity into your deal process

If you run a disciplined Business Acquisition Training program for your team, add a rollover module early in the pipeline. Your LOI should preview the size and basic terms of any rollover, not leave it to definitive documents. Include a memo from your lender, if possible, indicating how seller rollover affects underwriting. In management meetings, ask culture questions that predict partnership fit: how does the seller make decisions, what level of reporting are they used to, how do they react when a plan changes midstream? You are not just Buying a Business, you are buying a relationship that could last years.

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On your closing checklist, pair every legal concept with an operator’s question. For example, alongside “major decision rights,” ask, who signs off when a fleet vehicle dies? Alongside “distribution waterfall,” ask, what happens if we want to hire three sales reps ahead of plan? Doing this forces the documents to reflect real life.

When you should not ask for a rollover

Not every seller should stay in the boat. If the founder is burned out, in poor health, or emotionally done, a rollover can become a grudge. In some distressed or turnaround situations, fresh leadership and a clean break beat forced alignment. If you know you will pivot strategy hard on day one, the seller’s institutional memory might hinder more than help. Also, if the cap table will already be crowded with co-investors, managers, and lender warrants, adding a large seller rollover can make governance unwieldy.



There is also a reputational aspect. If your firm's message to intermediaries is that you always require a big rollover, you will lose deals where sellers need liquidity and certainty. Flexibility buys deal flow. Sometimes you pay a little more cash, win trust, and still generate strong returns.

Practical drafting tips that save headaches

Work from a plain-English term sheet for the rollover before you dive into the operating agreement. List the class of equity, percentage, vesting if any, board seat or observer rights, voting thresholds for defined major decisions, distribution policy with numeric guardrails, transfer restrictions, drag-along and tag-along terms, and repurchase mechanics on separation. If both sides agree in prose, the lawyers will have a cleaner target.

Define valuation mechanics for any buy-sell triggers without creating an appraiser circus. A single independent valuation firm with a shortlist pre-agreed, splitting costs, and a clear timeline works better than dueling appraisals. Set a floor and ceiling if you worry about gamesmanship.

Map the rollover to your management incentive plan. If your managers hold profits interests that vest on a sale, spell out how proceeds flow so the seller sees the waterfall and understands dilution math on day one.

The second bite and exit planning

Sellers say yes to rollovers because they want that second bite. You should want it for them too. A founder who sees a credible path to double their rolled stake will champion the business in the community, mentor the next layer of leaders, and pick up the phone when you need a favor with a legacy customer. Keep them informed post-close. Quarterly board packages, candid notes on wins and misses, and early warning on capital plans keep trust high.

When exit time approaches, engage the seller early. If they hold minority rights that could slow a sale, you do not want surprises in the last mile. Many agreements include drag-along provisions that compel minority holders to sell on the same terms if a majority approves, subject to fair treatment. Use them as a backstop, not a bludgeon. Most sellers will support a good exit if you have treated them fairly along the way.

Final thoughts from the trenches

Rollover equity works because it focuses everyone on building long-term value. It asks the seller to put belief behind their pitch and lets the buyer share risk without relying solely on paper covenants. The tool is adaptable, but the fundamentals repeat: set expectations early, document the real-world decisions you will face, keep the structure as simple as the risks allow, and respect the human being across the table.

If you are Buying a Business and want the seller on your side after the champagne cork pops, a well-structured rollover is one of the most reliable bridges you can build. Treat it like a partnership, not a loophole, and it will repay you with smoother integrations, stronger lender relationships, and exits that feel fair to everyone who helped create the value.