

Insights

SELLER ROLLOVERS: A PRACTICAL TOOL FOR TODAY'S M&A DEALS

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Negotiating an M&A transaction today is often highly complex, even emotional at times, requiring the parties to agree on numerous deal points. Market terms notwithstanding, the goals and interests of the buyer and the seller are often opposed, or at least not fully aligned. Take target company valuation, for example. Buyers are typically sensitive to overpaying, getting out of balance on capital allocation, or taking on more acquisition debt, particularly as interest rates have risen. Conversely, sellers seek to maximize purchase price, driven by competitive sale processes as buy-side competition remains fierce and sell-side valuation expectations remain elevated since the COVID-19 pandemic. As another example, consider a seller who will remain actively involved in the business after closing – how can the buyer encourage that seller to do what's best for the business, rather than the seller individually? These types of dynamics commonly faced in M&A transactions today can create greater distance between the negotiating positions of buyers and sellers. But savvy dealmakers know the potential of seller rollovers to help bridge the gap, foster alignment, and ultimately get a deal done.

What is a Seller Rollover?

A seller rollover is essentially a reinvestment by a seller back into the acquired business in connection with the acquisition. It is typically structured as an exchange of target company equity owned directly or indirectly by a seller for equity of equal value in the acquiring company or its parent company. As a result, the rollover seller continues to own part of the acquired business (or a larger business if the acquired business is combined with another business owned by the buyer) alongside the buyer (which typically retains majority ownership).

Rollovers are most common in M&A transactions where a financial sponsor, such as a private equity firm, independent sponsor or family office, or one of its portfolio companies, acquires a majority stake in a company owned, in whole or in part, by its founders or management team.

How Seller Rollovers Help Get a Deal Done

Various features of seller rollovers can help expand the size of the proverbial pie in deal negotiations. For buyers, they make certain economic points more palatable, better align seller

interests with buyer interests to continue growing the business post-closing, and provide additional security for seller indemnification obligations. For sellers, rollover equity may, with proper structuring, be received on a tax-deferred basis. Seller rollovers may also lead to higher valuation, provide sellers both liquidity and participation in future growth, and allow sellers to remain involved in their business post-closing. Each of these features is discussed further below.

Buyers' Perspective

Lowering Cash Outlay and Cost of Capital. One key feature of seller rollovers for buyers is that they reduce the amount of cash buyers need to acquire the target business. Rather than using entirely their own cash – or their investors' and lenders' cash – buyers effectively use sellers' equity in the target to help finance the acquisition, reducing the amount of financing needed and thereby lowering the cost of capital. This is especially helpful as interest rates have recently risen from historic lows, making acquisition financing more costly. Seller rollovers can also allow buyers to offer a higher purchase price because they do not have to pay the entire purchase price in cash. This can help buyers prevail in competitive auctions or bridge valuation gaps, which have become more prevalent since sellers' multiple expectations generally rose in post-pandemic M&A markets and have yet to come back down. Moreover, buyers may feel more comfortable with a higher price because sellers' willingness to reinvest in their business signals confidence in future performance. Reduced cash outlay also lowers buyers' equity risk exposure by sharing pricing risk with sellers, thereby reducing the economic downside for the buyer if the business doesn't perform well after acquisition, which can be especially valuable for riskier assets or when valuations are stretched.

Aligning Interests and Retaining Talent. Another feature of seller rollovers is promoting stronger alignment of interests between buyers and sellers. In the absence of a rollover, sellers may reduce their attention to the long-term value of the target business because they will no longer own the business after closing. By giving sellers continuing ownership in the acquired business, a rollover incentivizes sellers to continue focusing on long-term value because some of their money is still at risk in the business after closing. Similarly, rollovers help incentivize sellers to grow the business further post-closing, providing higher returns for buyers and sellers alike, and to stay with the business until those returns are realized. This makes rollovers particularly useful when sellers are critical to the continued success of the business. Moreover, because rollovers already give sellers incentive to perform, buyers may have more room in their incentive equity pool to incentivize and retain other key employees.

Securing Indemnification. Seller rollovers also give buyers an additional avenue of recovery for seller indemnification obligations. This can be useful for buyers to find compromise in today's competitive deal environment, where sellers, even in the private company context, often seek public company style walk-away deals, or at least more limited indemnity obligations than in the past. For example, buyers might be more comfortable with a smaller indemnification escrow, or no indemnification escrow at all, if the rollover equity is available as a source of recovery. In fact, it is becoming increasingly common for buyers to seek repurchase rights on rollover equity at a

discount, such as the lower of cost or fair market value, as a way to recoup some of the damage caused by sellers' breach. Similarly, while the rollover investment already provides sellers with significant incentive not to compete with or otherwise damage the business post-closing, buyers can use recourse to rollover equity to further incentivize compliance with seller restrictive covenants and facilitate recovery in the event of breach.

Sellers' Perspective

Deferring Taxes. One benefit of rollovers for sellers is the opportunity to reinvest in the target business – a business they know well – on a tax-deferred basis. With proper structuring, federal tax laws may permit sellers to defer tax on their receipt of rollover equity. So, instead of triggering tax on the entire value of the sale consideration at closing, tax on the rollover equity portion is deferred until sellers later cash out (typically when the business is sold to another buyer). To the extent that buyers can structure seller rollovers on a tax-deferred basis, sellers may find rollovers to be even more compelling.

Increasing Valuation. As noted above, seller rollovers can allow buyers to reduce the cash outlay required to fund an acquisition. One of the knock-on effects of this is that buyers may then be willing to offer a higher price for the target business, increasing total sale proceeds to sellers. Sellers therefore can use rollovers to increase their company's valuation. Seller rollovers also signal sellers' confidence in the business and willingness to partner with buyers to grow the business, creating greater alignment of interests and potentially leading to better deal terms overall.

Liquidity and Upside. Many sellers view a rollover as having their cake and eating it too. On the one hand, sellers receive substantial cash proceeds, providing liquidity and opportunity to diversify what was previously, in most cases, a highly concentrated investment. On the other hand, sellers remain invested in their business and thus continue to participate in any future appreciation as well. This feature makes rollovers especially attractive for sellers who are ready to monetize their efforts building their business, but also still believe in the quality or growth potential of the business and therefore want to remain invested as well.

Continuing Involvement. Depending on the negotiated terms, sellers may receive certain governance rights tied to their rollover ownership, such as a board seat or advisory role. This can allow sellers to influence the company's strategic direction even though they do not control the company anymore. This ability to remain involved can be particularly appealing to founders who aren't ready to let go of their baby or otherwise want to continue supporting their business and employees.

Drawbacks of Seller Rollovers

There is, of course, no such thing as a free lunch. For each positive feature of seller rollovers described above, there is often a corresponding drawback, though there are ways to limit drawbacks and make rollovers worthwhile overall.

Buyers' Perspective

For buyers, rollovers reduce their economic upside because rollover sellers will receive a share of operating profits and proceeds in a future sale. Rollovers also often require buyers to sacrifice some control over the acquired business by giving sellers certain governance and other rights in exchange for agreeing to rollover, or at least to deal with additional interested parties in the investment. These drawbacks are exacerbated when buyers and sellers have serious disagreements, such as over the strategic direction of the business, or when buyers make indemnification claims against sellers, straining the business partners' relationship. Buyers should therefore negotiate appropriate escape hatches, such as rights to repurchase rollover equity if serious problems arise, but they should also generally be prepared to deal with more cooks in the kitchen.

Sellers' Perspective

For sellers, receiving rollover equity reduces the amount of cash that rollover sellers receive at closing. Correspondingly, rollover equity is typically an illiquid, private-company investment that will not be realized until the company is sold again. It is also increasingly common for buyers to insist that rollover investments be made, in whole or in part, in a junior security, such that, in addition to governance control, buyers have economic priority on their equity relative to rollover equity. Further, as minority investors, rollover sellers have limited control over the acquired business, so the success or failure of rollover investments largely depends on buyers as majority owners. To help address these issues, sellers can negotiate for catch-up distributions on their rollover equity, as well as participation, liquidity, and governance protections, such as preemptive rights, tag-along rights, and board seats. However, sellers should also be prepared to be patient and compromising because they are not in the driver's seat.

Both Parties' Perspective

Lastly, for both sides, rollovers may increase the overall complexity of the transaction, drawing out timelines and increasing transaction costs. One thing that can limit the impact of added complexity is negotiating all key details of rollover investments in a term sheet – including type of rollover security and governance, liquidity, participation, and repurchase rights – not just the amount of the rollover. Establishing expectations early helps avoid situations where the parties expend negotiating capital and strain their relationship over rollover terms when they've already invested substantial time and money evaluating and negotiating the transaction.

Conclusion

Notwithstanding certain tradeoffs, buyers and sellers may be able to better achieve their respective goals in M&A transactions using seller rollovers. The potential for rollovers to bring parties closer together by achieving several of their respective goals at once makes rollovers a good tool for dealmakers in today's complex and competitive M&A market, especially in deals involving founder-

led businesses, high valuation multiples, and ongoing seller involvement in the business after closing.

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