

Breaking Down Rollover Equity: Why Buyers Love It and What Sellers Need to Know

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For many business owners, the goal of selling their company is turning their years, and often decades, of hard work into liquidity. But in some cases, retaining a stake in the company could prove to be fruitful for both the buyer and the seller. That is where rollover equity comes into play.

Below is a breakdown of the benefits and risks of rollover equity, and what sellers need to know.

Rollover Equity Explained

The concept of rollover equity is simple. Instead of paying a seller entirely in cash, a buyer acquires 100% of the target company while allowing founders and key shareholders to retain a stake in the new ownership structure. The seller still receives some immediate liquidity at closing, exchanging the remaining portion for equity in the post-transaction business.

This is certainly not a new concept and has been common in private equity transactions for some time. However, it is becoming an increasingly important tool today as buyers and sellers work to bridge valuation gaps and align their incentives in today's more cautious deal environment.

The Benefits of Rollover Equity

One of the most obvious benefits of this deal structure is that it reduces the amount of cash required to close a transaction. This is a significant benefit for buyers who are motivated to preserve capital whenever possible, particularly in today's market when financing costs are elevated, and lenders are scrutinizing leverage more carefully. Buyers do not have to fully fund a transaction with cash, but they still obtain full control of the entire company.

Additionally, when founders remain involved, there is an increased confidence that the management team and employees will remain motivated and stay onboard. Continued seller participation can also help to preserve relationships, maintain operational continuity, and retain institutional knowledge after the deal closes. These non-economic factors can be critical to the company's future success.

Rollover equity can also be a tool to bridge valuation disagreements between a buyer and seller. A frequent issue that arises is a seller's belief their business deserves a higher valuation based on its growth potential vs. the buyer's hesitation to fully underwrite those projections in cash. A rollover structure provides a bridge for both sides to move forward despite the disconnect on valuation. The seller gets to walk away with immediate liquidity while still retaining the opportunity to benefit from the upside if the company continues to grow.

That second bite at the apple can prove to be extremely valuable for a seller if the company later sells at a higher valuation.

They can see returns that far exceed anything they would have generated from an all-cash transaction up front. This makes rollover equity particularly attractive for sophisticated sellers who see the opportunity to continue participating in value creation alongside the buyer.

The Risks of Rollover Equity

While there are many upsides to rollover equity, it is not without risk. Most importantly, sellers must fully understand what they are receiving in exchange for the portion of the sale they are not receiving in cash. The rolled equity is typically a minority stake in a buyer-controlled entity. The seller will have minimal control over future decisions, including exit timing. Therefore, the rights associated with the rollover are incredibly important and should be carefully negotiated.

Rollover equity can also include some restrictions for the seller. For example, there can be mandatory hold periods, drag-along provisions, or other limitations that can affect how and when the seller can monetize their investment. The capital structure of the post-closing entity also matters. If the new entity is highly leveraged, the seller may face a very different set of risks than they did as the original owner.

As with any transaction structure, a rollover transaction comes with its own set of tax considerations as well. When structured properly, rollover equity can come with the added benefit of tax deferral in certain instances for sellers, but the rules here are complex and highly dependent on deal structure. It is essential to bring in legal and tax counsel early on to ensure everything is structured appropriately and aligns with the seller's financial goals.

Rollover equity can be a highly beneficial tool for both buyers and sellers, and it will no doubt continue to be increasingly used in today's M&A environment. But there are many considerations, especially on the sell side, that must be addressed from the start. Working with effective legal counsel throughout the process can help to reduce the risk, increase the benefits, and set up sellers for even greater success in the future.