Protecting Your Interests if You Receive "Rollover Equity" in a Transaction

In a sale of a company, the Seller might want to receive some equity ownership in the Buyer going forward. This is often referred to as "rollover equity" because the Seller would be "rolling over" some of the purchase price into equity going forward. Rollover equity is often attractive both to the Buyer (who doesn't have to come up with as much cash for the purchase) and to the Seller (who can invest in the business going forward with some of his purchase price). A Seller receiving rollover equity should first make sure that the transaction is structured in the most tax efficient manner. Then, the Seller should consider the best possible protections for its equity interest going forward. Usually, the Seller will only be receiving a minority interest in the Buyer. Because the interest will be a minority interest, the Buyer will be able to out-vote the Seller and thus the Buyer could approve certain actions that might adversely impact the Seller. For example, the Buyer could issue new stock to its majority owners (maybe at a discounted price) that would dilute the Seller's interest. The Buyer could also require the Seller to put up additional capital in the future or risk dilution or even be bought out. The Buyer could also take unwise business actions, or actions that benefit the majority owners to the detriment of the Seller, that would harm the Seller's investment. The majority owners could also sell their majority stake to some third party without including the Seller in such sale. A Seller should limit these sorts of potential actions by negotiating certain "minority protection rights" into its agreement with the Buyer.

Some typical minority protection rights include:

1. Having a seat on the Board of Directors so that, even if you are outvoted, you would have a "seat at the table."

2. The right to receive financial information about the Buyer on a regular basis (such as monthly, quarterly, and annually), which should include income and balance sheets but might also include annual budgets.

3. "Pre-emptive" rights or the right to participate in any new capital raise so that the Seller can maintain its ownership interest without being diluted.

4. Although a Seller wants "pre-emptive rights" to allow it to participate in any capital raise, it also doesn't want to be forced to put up additional capital. Thus there needs to be some protection against draconian capital calls whereby if the Seller doesn't participate, it is penalized or even subject to being bought out.

5. If the Buyer is taxed as a partnership, the Seller would also want to make sure there will be "tax distributions" (distributions from the Buyer to its partners to enable the partners to pay the tax on the income of the Buyer that, for tax purposes, is accrued to the partners).

6. "Tag-along" or co-sale rights in the event the majority owners want to sell. These would allow the Seller to be able to sell on the same terms and conditions as the majority owner is selling.

7. The Seller may also want a "put" right, which is the right to sell the Seller's interest back to the Buyer at a certain agreed upon price in the event the Buyer doesn't sell its company, or conduct an initial public offering, or otherwise provide a path for the Seller to be able to "cash out," within a certain agreed upon time frame.

We hope this newsletter has been helpful. If you are thinking about selling your business or buying a business, we can provide the experienced mergers and acquisition assistance you need.