You Sold the Business. How Much Risk Did You Actually Leave Behind?

Why wealth advisors should evaluate rollover equity as a new investment—not simply another component of the sale price.

By Joseph (JD) Durnford

A business owner receives an attractive offer from a private equity-backed buyer. Most of the consideration will be paid in cash. A portion will remain invested alongside the buyer, offering the opportunity to participate in another sale later.

The proposal can be compelling: take money off the table, gain a partner and retain some upside.

For the wealth advisor, however, the essential question is not how large that second payout could become. It is whether the first transaction accomplishes the client's financial objectives if the second payout disappoints—or never arrives.

Rollover equity can be a worthwhile investment. It is also a decision to keep capital at risk under a new ownership arrangement, often with less control over liquidity and strategic decisions. The rights attached to that investment deserve scrutiny independent of the sale price. [1]

The client is not simply selling less of the same business. The client may be selling one investment and acquiring a materially different one.

Separate the Seller's Decision From the Investor's Decision

Negotiating the sale and evaluating the rollover should be connected but distinct assignments.

As a seller, the owner wants an acceptable price, reliable payment and manageable continuing obligations. As an investor, the same person needs to understand the entry valuation, capital structure, governing documents, expected returns and downside exposure.

A useful question is: If the client received all the consideration in cash, would they choose to invest this amount in this security, on these terms, with this partner?

That question does not mean an all-cash alternative is available. A buyer may require meaningful rollover as a condition of proceeding. It does, however, expose whether the owner is accepting the investment on its merits or treating it as the unavoidable remainder of a successful negotiation.

If rollover is mandatory, the decision becomes whether the combined sale-and-investment package is better than the owner's alternatives. An attractive headline valuation does not answer that question.

Establish What the Percentage Actually Means

An owner may agree to roll 20% of their proceeds and assume they will own 20% of the post-closing company. Those are different calculations.

The resulting ownership depends on the equity value of the entity receiving the investment, the capital contributed by others, the securities issued and the fully diluted capitalization. The investment may be in the acquired business or a broader platform containing other operations. [1][3]

The wealth advisor should ask for an understandable bridge from the seller's consideration to the value and percentage of the new interest. What is the entry valuation? What businesses, debt and claims sit inside the entity? Does the percentage include the management incentive pool and other potential equity interests?

An independent ownership advisor can help reconcile that bridge and test the commercial assumptions. Counsel should confirm that the documents deliver the agreed rights. A percentage without a defined denominator is not an investment description.

Follow the Waterfall, Not Just the Growth Story

The business can grow without every equity holder participating equally in the proceeds.

Debt must be considered, as must any preferred claims that rank ahead of the seller's security. The sponsor and seller may hold the same class of equity—or securities with different economic priorities. Dilution can further change the seller's participation. [3]

Consider a simplified illustration, not a return forecast. Suppose a future sale produces $100 million of enterprise value. Debt repayment and exit expenses consume $60 million, leaving $40 million for equity. Assume the seller owns 20% of the residual common equity. If there are no senior equity claims, that interest receives $8 million. If a separate $20 million preferred claim must first be paid, the same 20% residual interest receives $4 million. Actual terms can produce different results.

The point is not that preferred equity is inherently inappropriate. It is that an ownership percentage cannot be interpreted apart from the distribution waterfall.

Ask the team to model proceeds under a disappointing, base and strong exit, using the actual debt, preferences, incentive arrangements and expenses. The client needs to see the return on their security—not merely the growth in the platform's enterprise value.

Distinguish Dilution Protection From a Cash Obligation

Future acquisitions, financing rounds or management incentives may reduce the seller's ownership percentage. Preemptive rights can allow an investor to maintain participation by purchasing additional equity, but exercising those rights requires more capital. They do not make dilution disappear at no cost. [2][3]

For a client who sold partly to reduce concentration, that creates a consequential choice: invest additional funds or accept a smaller stake.

The wealth plan should identify whether additional contributions are required, optional or subject to particular consequences under the documents. It should also reserve for any deliberately accepted funding commitment rather than treating all closing cash as permanently available for other goals.

The better question is not, “Are there dilution protections?” It is, “What must the client do—and spend—to benefit from them?”

Underwrite Liquidity Independently of the Sponsor’s Timetable

A projected exit date is not a contractual right to receive cash. Minority holders may have limited ability to sell their interests, while the controlling investor determines the timing and structure of an exit. Negotiated protections can help but do not eliminate the possibility of a prolonged holding period or disappointing proceeds. [3]

The advisor should establish what transfer restrictions, tag-along rights, drag-along rights and any negotiated liquidity provisions actually permit. These rights are not interchangeable: an ability to participate when someone else sells is different from an ability to initiate a sale. [1]

The financial plan should then test a longer holding period with no interim distributions. Essential spending, taxes, debt service and family commitments should not depend on a private investment becoming liquid on a convenient date.

This is not an argument that every client must be able to lose every dollar rolled. It is an argument that any dependence on that capital should be identified, quantified and consciously accepted.

Read the Employment and Ownership Documents Together

A seller who remains in management is both an employee and an investor. The documents should be reviewed together, because departure provisions may affect the treatment of the retained interest. Repurchase rights and the consequences of leaving the business deserve examination before the owner accepts the rollover. [1]

What happens after termination, retirement, disability or death? What triggers a repurchase, who can exercise it, how is value determined and when would payment occur? Distinguish purchased rollover equity from newly awarded incentive equity; do not assume the same vesting or forfeiture terms apply.

The wealth and insurance advisors should evaluate the practical consequences alongside counsel. A client may expect retirement flexibility that the combined employment and ownership arrangements do not support.

The investment decision is incomplete if it assumes the owner’s working relationship with the buyer will always remain satisfactory.

Do Not Let Tax Deferral Substitute for Investment Analysis

A rollover may qualify for tax-deferred treatment, but that result depends on the transaction structure, entity classifications and consideration involved. It should not be assumed. Alston

& Bird's tax guidance specifically recommends understanding the consequences at the letter-of-intent stage to avoid unexpected tax without corresponding cash. [4]

Deferral also is not the same as eliminating tax. The investment still needs to justify its economic risk after considering the applicable tax consequences. [4]

The tax team should establish the treatment of the transaction and the interest the client will hold. If the structure is a pass-through, the team should also examine potential taxable allocations, contractual tax distributions and the client's ability to meet the resulting obligations. These are document- and taxpayer-specific questions, not conclusions to infer from a presentation describing the rollover as tax-efficient.

Put Correlated Exposures Back Together

A transaction can leave the owner with rollover equity, a seller note, an earnout, continued employment and a property leased to the business.

Those may be separate legal arrangements. They are not necessarily separate economic risks.

If the business struggles, investment value, contingent payments, employment income and rent could all be affected. The wealth plan should assess that shared dependency rather than treating each item as an independent source of security.

I would separate the post-closing picture into four categories: cash available after taxes and commitments; fixed but credit-sensitive payments; contingent payments; and equity exposed to future performance. Then I would identify which personal objectives depend on each category.

Stress tests should include no distributions, a delayed exit, further capital needs and a substantial loss in rollover value. Upside belongs in the analysis, but it should not conceal the consequences of a less successful outcome.

Bring Ownership Expertise in Before the Terms Harden

An independent ownership advisor can help translate these questions into a coordinated commercial review: what the owner is selling, what they are receiving, what they are reinvesting and what remains exposed.

That work should include evaluating the proposed partner, examining the acquisition and growth thesis, reconciling the capitalization and waterfall, and comparing the package with realistic alternatives. It should distinguish returns supported by existing operations from returns that require successful acquisitions, higher valuations or substantial execution improvements. We lead the financial and business negotiation, working closely with counsel on the legal terms that give those decisions effect.

The title alone establishes nothing. The referring wealth advisor should verify relevant transaction experience, compensation, conflicts and the authority to perform any regulated activity. The engagement should complement legal, tax and investment advice, not blur those responsibilities.

The appropriate time to involve that expertise is before the letter of intent fixes expectations about rollover size, valuation and structure. Counsel and tax professionals should be involved early as well. Trying to resolve fundamental economics after exclusivity is a less attractive assignment than establishing them while alternatives remain.

Define Success Before Agreeing to the Second Investment

A successful rollover can add meaningfully to an owner's wealth. A carefully chosen partner may provide resources and capabilities the business did not previously possess. Those possibilities deserve serious consideration—not automatic skepticism.

But the prospect of a second payout should not obscure the purpose of the first transaction.

For a wealth advisor, the essential discipline is to separate the financial independence the sale is intended to secure from the entrepreneurial risk the client is choosing to retain. Make the liquidity assumptions explicit. Understand the security. Model its place in the capital structure. Test the plan against outcomes that do not match the presentation.

When those questions exceed the team's transaction experience, involve an independent ownership advisor while the terms can still be shaped.

The client may be ready to sell the business. Make sure they understand the investment they are agreeing to own next.

About the Author

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