William Blair

williamblair.com

Five Highlights of Rollover Equity and Management-Equity Incentives

Rollover equity—when the current shareholders of a business are required to reinvest a portion of sale proceeds (tax-free, typically) in the newly formed company—has become increasingly common, especially when selling to a financial investor (e.g., private equity or a family office). As a result, owner-operators pursuing a liquidity event should become familiar with rollover equity and management-equity incentives.

Like rollover equity, management-equity incentives (commonly known as stock awards/options) can help keep owner-operators committed to the company's success while aligning the long-term financial interests for the next sale. Key executives (CEO, CFO, etc.) and other team members deemed essential to driving future value creation receive these equity-based rewards. They are typically a blend of time-vesting and performance-based units with the intent to be flexible and aligned to the management team's objectives.

The precise rollover requirements and equity incentive package are negotiated during the sale process. Below are five key highlights for business owners:

1. **Impact on Valuation**
   Financial investors are typically more aggressive on valuation and terms when current management is committed to having more "skin in the game" and rolling a significant amount of their proceeds into the next transaction.

2. **Oversight and Governance**
   Management's rights as equity shareholders are usually pari passu (on an equal basis) with the financial investor. A board of directors will be established—typically five to seven seats with one or two for management, one or two for independent directors, and the remainder for the new financial investor—to help oversee company performance.

A Premier Advisor for Nearly Nine Decades

Since 1935, William Blair has guided owners of closely held businesses and their trusted advisors through monumental decisions. Our relationship-driven approach empowers owners to maximize the value of their businesses—and turn that capital into an enduring legacy. We invite you to contact us to discuss the ways we support and advise business owners and help our clients capitalize on the tremendous opportunities available to them today.

3

Equity Options

Financial investors want to align their incentives with current management and drive meaningful wealth creation in addition to any rolled equity. The compensation packages vary with every transaction, but a 10% equity option pool of the fully diluted ownership is typically awarded. Most options are reserved for current management with the remainder for future key employee hires.

4

Management Agreements/Noncompetes

Key management will usually sign employment agreements tied to a noncompete. The length of the agreement varies widely depending on go-forward role but usually is between three and five years. Any management members who breach their contracts can forfeit certain equity incentives. It is important to work with an executive compensation attorney to review any employment agreements before signing.

5

Potential Tax Advantages

Rollover equity is usually structured on a tax-deferred basis, allowing for business owners to defer capital gains taxes until they receive cash proceeds from a future sale. Depending on the type of transaction, Section 1202 could be applicable and allow owners to continue their qualified small business stock (QSBS) hold periods.

In addition to familiarizing themselves with these concepts, owner-operators considering working with a financial investor can seek outside counsel to help navigate this new terrain. Doing so can be helpful before—and after—a major liquidity event.

For more information, please contact:

Andrew Hansen
+1 312 364 5439
ahansen@williamblair.com

Sam Longenecker
+1 312 364 5237
slongenecker@williamblair.com

“William Blair” is a trade name for William Blair & Company, L.L.C., William Blair Investment Management, LLC and William Blair International, Ltd. William Blair & Company, L.L.C. and William Blair Investment Management, LLC are each a Delaware company and regulated by the Securities and Exchange Commission. William Blair & Company, L.L.C. is also regulated by The Financial Industry Regulatory Authority and other principal exchanges. William Blair International, Ltd is authorized and regulated by the Financial Conduct Authority (“FCA”) in the United Kingdom. William Blair only offers products and services where it is permitted to do so. Some of these products and services are only offered to persons or institutions situated in the United States and are not offered to persons or institutions outside the United States. This material has been approved for distribution in the United Kingdom by William Blair International, Ltd. Regulated by the Financial Conduct Authority (FCA), and is directed only at, and is only made available to, persons falling within COB 3.5 and 3.6 of the FCA Handbook (being “Eligible Counterparties” and Professional Clients). This Document is not to be distributed or passed on at any “Retail Clients.” No persons other than persons to whom this document is directed should rely on it or its contents or use it as the basis to make an investment decision.