Typical Minority Ownership Issues Facing Rollover Participants

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PE buyers and target company owners are rightfully focused during the M&A process on the terms of the purchase. Often the tax structure receives careful attention, particularly where a tax-free rollover requires sellers during an M&A transaction are rightfully on M&A transaction that includes a rollover component. Less frequently a center of attention during the negotiations but of equal importance are the rules governing the ongoing relationship between the buyer and the rollover participants.

The following issues list is viewed from the perspective of the rollover participant but can provide useful background information for buyers trying to get deals over the goal line:

- **Mandatory tax distributions.** The inclusion of a mandatory tax distribution is critical to minority owners of a pass-through LLC who don't have any control over whether permissive distributions will be approved by management.
- **No involuntary additional capital contributions.** A minority owner doesn't want to be forced to make involuntary capital contributions.
- **No involuntary loans or personal guarantees.** A minority owner doesn't want to be forced to make loans to the company or have an open-ended requirement to guarantee company obligations.
- **Understanding the potential for dilution.** A minority owner benefits from pre-emptive rights and an understanding of when and how dilution can occur. Typical exceptions to preemptive rights include the issuance of equity compensation and the redemption of equity in connection with the reissuance of shares to new investors.
- **Board representation.** Depending on the percentage of equity represented by the rollover participants' holdings, rollover participants may have board representation (in

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addition to a seat for a rollover participant continuing as the company's president/CEO) or observer rights.

- **Governance issues and management fiduciary duties.** The buyer entity's governance documents, particularly when the entity is an LLC, often requires owners to waive the fiduciary duties of care and loyalty otherwise applicable to the financial buyer's board representatives or managers. In many cases, the documentation will go further and provide that the financial buyer and its representatives are permitted to approve decisions that further their interests rather than making decisions based on what is best for the LLC or the rollover participants.
- **Supermajority voting rights.** Rollover participants with a substantial ongoing stake in the portfolio company should consider negotiating for supermajority voting rights on key decisions. In many cases, however, buyers will not be willing to grant the rollover participants a meaningful vote on matters other than consent rights associated with a PE firm conflict of interest transaction. Some key issues that might be the subject of a supermajority consent requirement include: (i) amending the buyer's organizational documents; (ii) the making of a non-pro rata distribution to owners not contemplated in the LLC agreement; (iii) the making of non-pro rata redemptions (other than upon termination of employment); (iv) the dissolution or liquidation of the buyer entity; (v) increasing or decreasing the number of directors; (vi) equity redemptions not contemplated in the buyer's LLC agreement; and (vii) consent rights with respect to asset purchases or sales exceeding agreed-upon threshold.
- **Sponsor fees.** PE firms typically receive 20% carried interest (profits interest) and pursuant to a support and services or management fee an annual management fee equal to 1.5% to 2% of committed capital. There may be other fees, including directors' fees, acquisition and disposition fees, and monitoring fees.

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- **Information and inspection rights.** Rollover participants usually have a right to periodic financial statements and typical equity holder information rights, but careful attention should be paid to any restrictions on those rights set out in the LLC operating agreement or a separate equity holders agreement.
- **PE firm repurchase rights upon termination of employment.** Most rollover equity is subject to repurchase rights upon termination of employment. In most deals, the repurchase right is based on some reasonable fair market value calculation, but the terms of the repurchase should be carefully reviewed.
- **Registration rights.** Many PE firms include the granting of securities (demand and piggyback) registration rights in their investor documents.

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