

# Buy-Sell Agreements May Not Be the Holy Grail, But They Can Help Limit Headache and Heartache

Article By:

Ladd Hirsch

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Disagreements are common between business partners in private companies, but most do not lead to a partner exit. When partner conflicts become severe enough to warrant a business divorce, however, majority owners and minority investors will both be well-served if they have taken the time to negotiate and implement a “corporate prenup.” If partners have not adopted a partner exit plan, the disputes between them may be both costly and prolonged when a partner departs. While there is no perfect Buy-Sell Agreement (BSA), a well-crafted contract will enable a business divorce to take place in a manner that limits disputes between the partners, which saves time and money.

## Why a Buy-Sell Agreement Is Necessary

The chief reason that a BSA is necessary is that it gives both sides something they need when serious disputes arise between the co-owners. The majority owners do not want to be saddled forever with a minority partner who is causing problems for them in the business. For their part, minority investors who have strong objections to the actions of the majority owner do not want to be stuck holding an ownership interest in the company that they cannot monetize. The BSA, therefore, allows the majority owner to redeem (buy out) the minority investor’s interest. It also allows the minority partner to secure a redemption (sale) of his or her stake in the business. Thus, both sides are able to secure a business divorce when they decide it is necessary.

## The Key Elements of a Buy-Sell Agreement

There are four chief elements of a BSA, which are discussed below. These are not cookie-cutter documents, and each of these terms will need to be discussed at some length by the co-owners to reach an agreement that meets their specific needs.

### 1. The Trigger

The first element is the trigger, which is the point in time at which the BSA can be exercised. It is fairly standard for majority owners to have the right to purchase the minority owner’s interest when he or she (i) files bankruptcy, (ii) gets divorced, (iii) dies or (iv) leaves the company. These are closely held companies, and the majority owners do not want strangers to be injected into the business.

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Majority owners also want the right to be able to pull the trigger and buy out the minority owner whenever they desire so that, at the first hint of problems, they can remove any disgruntled/difficult minority partner. But the minority partner who is making an investment in the company may resist an early exit and require that the investment be given sufficient time to appreciate in value so that the investment will have been worthwhile. The minority owner may therefore insist that no buyout right can take place within the first three to four years after the investment. The minority owner should also require that any buyout take place pursuant to a **look-back provision**. This provision provides that if any sale or other transaction takes place that places a higher value on the company within a year (or longer) after the minority interest has been redeemed, the minority owner will receive a supplement payment that provides the minority owner with the benefit of the increase in value.

The minority owner will want the right to demand that his or her interest be purchased whenever the minority owner desires to exit the business. The majority owner is unlikely to want to permit the investor to be able to pull the plug shortly after an investment is made in the company. The majority owner may therefore require that the minority investor has no right to request redemption for at least three to four years (or longer) after the investment has been made. Similarly, the majority owner may require that all of the minority investor's stake in the company be redeemed at one time so that the majority owner is not required to deal with multiple exercises of redemption by the minority investor.

## 2. The Value of the Redeemed Interest

Private company valuation is no easy task, and highly regarded valuation experts may reach very different opinions about the value of the ownership interest that is being redeemed. As a result, the co-owners should spend time considering how they want to go about determining the value of the business and the interest being redeemed when a buyout is triggered. In this regard, it is often helpful to retain a business valuation expert to help draft the valuation provision and how the process will take place.

Some of the components that the parties need to consider in valuing the redeemed interest include:

- What is the date of valuation (should it be the date the buyout is triggered, or should it be a specific date of the year, e.g., December 31, regardless of the trigger date)?
- Should the value be based on a single date or should it be a composite/average of the company's value over the past two to three years?
- Do minority discounts apply to a minority interest based on lack of marketability and the lack of control or should the value not include any minority discounts?
- Should the value be based on a specific formula based on the company's financial documents or should value be determined by business valuation experts and, if so, which one(s)?

Merely agreeing to retain a business valuation expert is not sufficient. The expert needs to be instructed whether minority discounts apply to the value, whether a single valuation date is being used or whether the value should be based on an average value based on a period of years, as well as whether the value should include or omit retained earnings and/or working capital.

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### 3. The Payment Terms

In addition to setting forth how the value of the interest to be redeemed will be determined, the BSA also needs to define how the price will be paid. The payment of a shareholder redemption often takes place over three to five years, although some BSAs provide for an even longer payout. Given the length of time for the payout to be completed, the BSA may provide for some type of collateral in the event there is a default in payment. The BSA must also specify whether the redeemed interest is transferred at the time the transaction takes place, or whether the transfer takes place over time as payments are made. While it is more common for the redeemed interest to be fully transferred at the same time as the redemption, that is not always the case.

### 4. Dispute Resolution Process

The final element of the BSA is the method selected for resolving any disputes between the partners that take place during their business divorce. Given the desire of all parties for the process to be completed promptly, they may choose to arbitrate these conflicts rather than engage in litigation. If arbitration is their choice, they have the option to require that the final arbitration hearing take place on a fairly rapid timetable, perhaps in 90-120 days. This ensures that they will have a prompt final separation of their joint ownership interest in the business.

## Conclusion

Even when parties going into business together are family members or longtime friends who trust each other, they are wise to plan ahead. By putting a BSA in place, they are preparing for possible outcomes that make a partner exit necessary. It is certainly possible that death, divorce or significant changes in their business goals may cause them to seek a business divorce, and they will appreciate their foresight in having taken the time to carefully negotiate and implement a corporate prenup.

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