

Determining fair market value in Canadian management equity repurchases

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Authors: [Niko Veilleux](#), [Marissa Kyres](#)

While private equity sponsors commonly rely on the board of directors to set the repurchase price of management equity upon a manager's departure, alternative valuation mechanisms are available and may be better suited in certain circumstances.

Introduction

In Canadian private equity (PE) acquisitions, members of management typically "roll" the totality or a portion of their equity stake into, or are granted a meaningful equity interest in, the portfolio company, often as much as 20% of the post-transaction capitalization. These equity-based incentives serve as a primary tool for PE sponsors to attract, retain and motivate key executives.

When a manager departs from a portfolio company, the PE sponsor will generally hold the contractual right to repurchase the manager's equity (a call right), and the manager may, in certain circumstances, also have the right to sell all or part of that equity (a put right). The repurchase price in these contexts is usually determined with reference to the fair market value (FMV) of the equity at the time of departure. For privately held companies, where no public market exists to establish an objective price, the parties must agree on a mechanism for determining FMV. The three most common approaches are

1. valuation determined by the board of directors
2. appraisal by an independent third-party valuator
3. a formula based on predetermined financial metrics

Determining the repurchase price is a critical and often heavily negotiated aspect of management equity arrangements, with important implications for both management and sponsors. The chosen methodology will influence not only the financial outcomes, but also the efficiency of the repurchase process, the likelihood of disputes and the stability of the ongoing sponsor-management relationship.

Triggers for management equity repurchase

Considerations around the valuation and repurchase of management equity — whether in the form of management incentive awards (such as stock options, stock appreciation rights,

restricted shares, restricted share units or phantom shares) or in the form of rollover and co-investment interests acquired alongside the sponsor — typically arise when contractual call or put rights become exercisable following the termination of a manager's employment. Repurchase pricing generally turns on three variables:

1. the type of right being exercised (call versus put)
2. the category of equity at issue (incentive awards versus rollover or co-investment equity)
3. whether the manager's departure qualifies as a "good-leaver" or "bad-leaver" event

Where a call right is exercised with respect to management incentive awards, the repurchase price is typically tied to the circumstances of the manager's departure. In a bad-leaver scenario (such as termination for just cause or resignation without "good reason"), the selling manager is typically entitled only to the lesser of

1. the original amount paid for the equity, if any
2. the FMV of the equity at the time of repurchase

This outcome effectively strips the manager of any appreciation the portfolio company realized during the sponsor's ownership period and serves as a deterrent to bad-leaver departures.

Conversely, in a good-leaver scenario (such as termination without cause, retirement, death or permanent disability), the manager is generally entitled to both

1. a return of cost (if any) with respect to unvested awards
2. payment of full FMV for vested incentive awards, thereby allowing the manager to realize the economic value they contributed to creating

Where the call right extends to rollover or co-investment equity, the governing agreements usually provide that the repurchase price will be FMV regardless of the circumstances of the departure. Since these interests are purchased with the manager's own capital risk at the time of the buyout, sponsors typically acknowledge that the manager should participate in value appreciation even if they depart as bad-leavers.

Where granted, management put rights are typically limited to good-leaver departures. In practice, the valuation mechanics generally align with those applicable to good-leaver call rights for rollover and co-investment equity, with the repurchase price set at FMV.

Methods for determining FMV

Where FMV is established as the operative standard for repurchasing management equity, the parties must agree on the method by which that value will be determined. When selecting an appropriate framework, the overriding objective should be to adopt an approach that is practical to implement, defensible in the event of a dispute and capable of consistently and accurately reflecting changes in the company's value over time.^[1]

Board-determined FMV

In most management equity repurchases, the board of directors of the portfolio company determines FMV, acting "in good faith." This approach is widely favoured for its efficiency and cost-effectiveness, particularly in routine or lower-value repurchases where the cost of retaining an external valuator would be disproportionate.

Boards are generally well positioned to undertake this role, as they typically have access to the sponsor's internal models, projections and market data, which enables them to establish

a realistic and defensible valuation without relying on external advisors. Boards can also promote consistency by ensuring that the same methodology is applied across grants, subsequent issuances and repurchases. This continuity allows stakeholders to easily track how management's equity value evolves over time and ensures that changes in repurchase prices reflect the portfolio company's actual performance, rather than shifts in methodology. A stable and predictable framework also reduces the risk of disputes by avoiding perceived shifts in methodology or the introduction of new approaches that may be viewed as unfair or self-serving.

From the sponsor's perspective, this model is often preferred because it allows sponsor-nominated directors to exert meaningful influence over the valuation process.

Independent third-party appraisal

In some cases, the parties may agree that FMV will be established by an independent third-party appraiser, such as an accounting or valuation firm. This approach is generally considered the most objective and reliable method of establishing FMV. A valuation prepared by a qualified expert with recognized credentials, and in accordance with accepted market practices, provides both the board and the PE sponsor with a strong basis to defend the outcome if it is later challenged. Outsourcing this process can also reduce the risk of direct confrontation between the PE sponsor and a departing manager, thereby helping to preserve working relationships with the remaining management team.

Management often prefers independent appraisals because they mitigate concerns that a sponsor-controlled board might undervalue the shares to the detriment of departing management. Engaging an impartial third-party provides reassurance to management that their equity is being valued objectively and fairly, which is particularly important in contentious departures or where significant sums are at stake.

There are also circumstances where the board may lack the expertise, resources or access to the market data needed to determine FMV internally. In such cases, turning to a third-party valuator may not only be prudent but necessary to ensure that the valuation is both defensible if challenged and more likely to be accepted by both management and the sponsor.^[2]

However, third-party appraisals can add significant costs, which may be disproportionate in the context of smaller repurchases. The process also tends to be more time-consuming, as external firms often need to build valuation models specific to the company and the repurchase circumstances, rather than relying on existing internal models or data already maintained by the board. Finally, outsourcing can reduce transparency, since the assumptions and methodologies underlying the analysis are not always fully visible to either management or the PE sponsor.

Formula-based valuation

In some cases, the parties rely on a predetermined formula to determine the repurchase price of management equity. These formulas are typically set out in the governing agreements and are tied to a financial metric, such as a multiple of the portfolio company's trailing twelve-month EBITDA, or by referencing a revenue, net income or cash flow.

The key advantage of this method is clarity and predictability. By specifying in advance how FMV will be calculated, the parties reduce the risk of disputes over which assumptions or valuation methods should apply. It also lowers costs, since there is generally no need to retain an independent appraiser for each repurchase, apart from possibly verifying the calculation. This avoids the need for negotiations or third-party input each time.

However, formula-based approaches are sometimes criticized for being overly rigid. They assume relative stability in the company's business model and may fail to account for significant changes such as new product launches, regulatory developments or major acquisitions or divestitures. In such cases, the formula may no longer accurately capture the true drivers of value.

Corporate governance considerations

Regardless of which valuation methodology is adopted, the board of directors remains ultimately responsible for overseeing the valuation process and formally approving both the repurchase price and the related transaction, whether by way of a board meeting or a written resolution.

In doing so, directors are bound by their fiduciary duties. They must act with care, diligence and good faith, consistent with the standard of a reasonably prudent person in comparable circumstances. Furthermore, under Canadian corporate law, directors cannot delegate share repurchase decisions, except where a unanimous shareholders agreement provides otherwise (see section 115(3)(e) of the *Canada Business Corporations Act*). As such, directors must themselves exercise judgment and care in approving both the valuation process and the resulting price. In addition to approving the purchase price, and even where an external valuator is engaged, the board remains responsible for ensuring that the valuator engaged is truly independent and qualified, that the scope of work and methodology are appropriate and that the process is conducted fairly and transparently.

To protect both their own interests and those of the company, directors should maintain detailed records of their decision-making process. Where circumstances warrant it, such as when the subject matter is particularly complex or extends beyond their expertise, they should also consider obtaining independent advice or expert assessments.

Preferred valuation approaches

The choice of valuation methodology often reflects the relative bargaining power of the parties and their respective risk profiles.

Private equity sponsors

PE sponsors generally favour board-determined valuations. With sponsor representatives often serving on the board, this approach provides them with greater influence over the process and the ability to align outcomes with broader sponsor objectives. It also offers practical advantages, such as lower costs and increased efficiency, particularly in routine repurchase situations where commissioning an external appraisal may not be justified.

Members of management

Senior executives, founders and other management stakeholders with significant equity stakes generally insist on more objective and independent valuation mechanisms, such as predetermined formulas or third-party appraisals. Such mechanisms limit discretion, promote transparency and provide management with greater confidence that their interests will not be compromised through undervaluation. By contrast, junior managers and smaller equity holders often lack the leverage to negotiate such protections and are more likely to accept board-determined valuations without verifying or challenging the process.

Hybrid approaches

In practice, even where the board retains discretion, it is common for the board to

supplement their analysis with a fixed formula or an external appraisal. This hybrid approach helps to ensure that valuations are defensible, instills confidence among stakeholders and demonstrates that the board has acted with diligence and good faith.

Concluding remarks

In management equity repurchases, FMV is typically determined by the board of directors, through an independent third-party appraisal or pursuant to a formula agreed in advance. In common practice, valuation decisions incorporate elements of more than one approach, with formulas or external valuations often used to support or corroborate a board-determined outcome.

Regardless of the methodology employed, the valuation process should be carefully documented, conducted in a procedurally fair manner and implemented in a way that is consistent with the board's statutory and fiduciary duties.

[1] Hugessen Consulting, "[Navigating Long-Term Incentives for Private Companies](#)," October 2024.

[2] "[Directors' Responsibilities in Canada](#)" [PDF], Osler, Hoskin & Harcourt LLP, October 2014.