

Getting vesting right: aligning incentives around carried interest in private equity

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In the world of private equity, the promise of carried interest is one of the most powerful tools for attracting, retaining and motivating talent. But the mechanics of how and when that carry is earned—known as vesting—can be the difference between a well-aligned team and one fractured by misaligned incentives. Designing an effective carried interest plan requires more than boilerplate terms; it needs a thoughtful approach that takes into account the firm’s goals, culture and investment horizon.

What is vesting in the context of carried interest?

Vesting is a term of art that can have different meanings. However, in the carried interest context, it generally means the period during which employees become entitled to carried interest payments. Said another way, carry, or any portion of it is considered vested when the payment entitlements are no longer subject to forfeiture upon a termination of employment, save and except for certain “bad actor events” which may result in a forfeiture of vested carry. For investment professionals, carried interest is often the most significant component of long-term compensation, so the vesting terms signal how the firm views contribution, commitment and performance.

In private equity, vesting can be tied to continued employment over a period of time or specific investment events. A common time-vesting schedule would provide that carry vests rateably over the vesting period (most commonly annually or quarterly). Alternatively, it could have a cliff of some sort (i.e., a period of time before the ratable vesting commences) or the inverse, with a tranche of the carry allocation vesting close to or at the end of the fund’s life.

Key design considerations

Here are the main elements to consider when designing a vesting arrangement that creates alignment and supports firm strategy:

1. Time-based vs. deal-based vesting

Time-based vesting provides predictability and helps retain professionals across the fund’s life. However, in deal-based or “deal-by-deal” carry structures, linking vesting to participation in specific investments can feel fairer and more meritocratic—those who work on a deal share in its upside.

Increasingly, we are seeing Canadian sponsors adopt “total fund” carry structures, with sponsors wanting to incentivize their teams to support overall fund success, and build a collaborative and “firm-first” culture.

2. Treatment on departure

What happens when someone leaves before fully vesting? This is one of the most sensitive and consequential aspects of any carry plan. Consider the following:

- Good leaver vs. bad leaver: Most plans distinguish between voluntary and involuntary departures. A good leaver (e.g., someone who retires or departs amicably) will typically retain all of their vested carry and possibly some unvested carry. A bad leaver (e.g., someone who is terminated for just cause or who leaves to join a competitor) typically forfeits unvested carry and all or a portion of their vested carry.
- Acceleration provisions: Should vesting accelerate in the event of death, disability, retirement or change in control? We see acceleration clauses from time to time, but these should be balanced with fairness to other team members.

3. Recycling and reallocation

Unvested or forfeited carry, whether due to departure or underperformance, creates a pool that can be reallocated. Deciding how to redistribute this carry (e.g., to high performers or new hires) can be an effective instrument for incentivizing and managing the team over time. Having a clear policy, or at least a framework, is valued by the investment professionals because it fosters transparency and fairness. However, having the flexibility to reallocate carry depending on various factors at any given time, and not having any hard and fast rules, allows the sponsor to optimize carry as a powerful incentive tool.

4. Alignment with fund lifecycle

In a typical private equity fund, value creation can often happen later in the fund's life. For that reason, some sponsors who wish to address this dynamic will use back-loaded vesting, where a portion of the carry is held back and vests in later years. Alternatively, some funds will use hurdle events (like reaching a certain IRR or DPI) to reinforce long-term focus.

Final thoughts: one size does not fit all

There is no perfect vesting model; what works for a megafund may look very different from the optimal plan for a first-time manager or a growth equity team. The best vesting arrangements are those that reinforce your firm's values, incentivize long-term value creation and provide clarity for your team.

A good rule of thumb: design the vesting plan with the same care you would use to structure a deal. Consider the downside scenarios, think about incentives over time, and make sure your carry plan communicates a clear story about what success looks like, and how it will be shared.

To discuss these issues, please contact the author(s).

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