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Collision Course—Can Private Equity and Law Firms Coexist?

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There is increasing interest within the legal community in partnering with private equity (PE) firms, for reasons that range from tapping into financing capital without the restrictions of traditional loans to drawing on the potential benefits derived from being part of a broader business network. On the other side of the equation, PE firms have shown similarly growing interest in investing in law firms and their potential returns.

The following analysis examines the structural and regulatory constraints that these types of partnership arrangements may present and offers insights into key considerations for law firms and investors evaluating such partnerships.

The Private Equity Model: Objectives and Investment Strategy

PE firms view the law firm marketplace as a potentially significant profit center, particularly in cases where inherent operational inefficiencies in management, marketing, and networking can be improved. However, meeting the financial objectives of all parties requires a management partnership as well as a funding one, which could lead to control issues that pull against the interests of each group, as PE fund managers ultimately serve their investors and law firms prioritize the interests of their clients and the judicial system.

Courtesy photos

(l-r) Robert B. Hille, Jennifer A. Belardo, and Sukrti Thonse, with Greenbaum, Rowe, Smith & Davis.

Lessons from Healthcare: Private Equity's Track Record in Professional Services

The experience of PE investment in healthcare provides a useful point of comparison, as PE has already established a significant track record in the medical field with inconsistent results.

Like lawyers, medical professionals owe a fiduciary duty and duty of loyalty to those they serve and are prohibited from allowing non-professionals to control the exercise of their professional judgment. For physicians, this prohibition falls under the Corporate Practice of Medicine (CPOM) doctrine.

In the healthcare field, PE has largely sidestepped this corporate control restriction by structuring arrangements in which a physician

retains formal control, while PE provides financial, billing, and management services. At face value this model appears to preserve professional independence, however in reality, physicians rely heavily on PE advisers.

In theory, these arrangements were intended to improve the financial positions of healthcare practices and professionals. Due to increased regulation and lower reimbursement, many healthcare providers were experiencing declining profitability while billing functions and issues were simultaneously increasing costs. Consequently, healthcare professionals viewed PE partnerships as a means to increase profitability through increased reimbursement and lower billing costs.

Since the 1990s, PE has developed a strong presence in the healthcare marketplace. However, there is debate as to whether these arrangements have benefited healthcare professionals or instead diverted profits to PE investors, hastening a financial decline for the profession and converting physicians from independent professionals to employees.

The impact on patients and the healthcare system has also been questioned. In a July 2024 report titled “Predatory Private Equity Practices Threaten Americans’ Health and the Economy,” the U.S. Congress Joint Economic Committee examined the adverse consequences of PE investment, identifying it as associated with potential over-prescription of procedures, shortages in medical equipment, poorer quality of care outcomes, lower patient satisfaction scores, higher rates of mortality, reduced compliance with Medicare standards of care, greater incidence of negative outcomes for patient health, lower ratio of employees-per-occupied beds, and hospital closures.

Taken together, these outcomes suggest that the gains from PE’s largely unregulated investment resulted in a long-term deterioration in benefits to healthcare entities, workers, and patients.

Converging Pressures: Market Dynamics, Professional Obligations, and Risk To PE

A significant difference between the practices of law and medicine is that the legal sector is less reliant on government and third-party reimbursement sources, with fewer regulatory restrictions on what lawyers can charge. Still, both professions face similar challenges, including those related to administrative efficiency, cash flow, marketing strategies, and management structures. Law firms are also contending with the rising cost for legal services, which is driving greater numbers of potential clients to “represent” themselves, often with assistance from AI. Thus, while a government entity is not restricting what a law firm can charge, market forces may be limiting reimbursement for attorneys. Because the practice of law, like medicine, is labor intensive, there is increasing pressure to find a more profitable business model.

While these factors present investment opportunities, they also pose significant risks for PE in the legal market. The PE investment model is illiquid, typically relying on a seven-to-ten-year investment horizon to drive returns. This long-term commitment, combined with the limited ability to buy, sell, or merge law firms, increases the risk of low or no returns compared with investments in other markets.

Before turning to PE, law firms must understand the model and its interests and compare those to more traditional funding sources.

The Private Equity Model in Practice: Structure and Incentives

As described by the investment firm Blackstone in “Essentials of Private Equity,” PE involves the pooling of investor money into funds managed by such firms to acquire and grow companies.

Despite these potential advantages, concerns have been raised regarding transparency and oversight. In an article titled “Regulation of Private Equity in the U.S. Reveals Deep Problems for Investors,” economist Eileen Applebaum notes that while PE firms are accountable to the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and the Dodd-Frank Act (2010), among others, they are among the least transparent financial entities. While all but the smallest PE and hedge

funds are required to register and report to the SEC, that information is not publicly available.

According to Blackstone, PE generally looks at how to unlock growth potential to take firms to the next level, how to strengthen or reshape management in ways not possible for most public equity investors, and how to create synergies between portfolio companies by leveraging expertise and networks to improve operational performance.

Blackstone also notes that the tool kit for PE managers includes:

- Informational advantage
- Staying power
- Operational intervention
- Strong governance
- Deal sourcing

The PE model is designed to place investors first, viewing professional entities such as law firms—and their clients—as potential profit centers. PE's focus is solely on whether a law firm can increase the value of its fund over seven to ten years and outperform investments elsewhere. If these objectives are not achievable, the law firm is an unlikely candidate for PE investment. However, if PE can enhance valuation by consolidating several firms, the objective shifts from an individual relationship to a market-wide one. This latter approach often benefits early participants in the arrangement and diminishes returns for late arrivals, eventually freezing out law firms seeking to maintain their independence. This, along with AI, could also accelerate the limitation of opportunities for legal professionals, paralegal professionals, and staff in the future.

Viewing PE's interests and objectives from a law firm perspective, a firm first needs to determine what it can accomplish on its own employing PE strategies. If it can do this profitably, a PE partnership is unnecessary. If not, the firm needs to weigh whether the control limitations inherent in the PE model are something the firm is willing to accept. The firm's affiliated legal professionals also need to weigh whether their obligations to clients and the system can be reconciled with a PE partnership.

Regulatory Framework and Ethical Constraints: Control of the Practice of Law

Structural tensions are further constrained by the legal and ethical framework governing the practice of law.

As the U.S. Supreme Court noted in *Konigsberg v. State Bar of California* in 1957, the regulation of the practice of law falls under the exclusive control of the states. In New Jersey, the state's Supreme Court exercises sole authority over that obligation, and any business relationship must be structured accordingly.

The two primary interests of New Jersey law governing lawyers relate to placing the client's interest over the lawyer's and preserving the public's confidence in the justice system.

New Jersey's Rules of Professional Conduct, under RPC 1.7, prohibit conflicts of interest in order to preserve the lawyer's undivided duty of loyalty to the client. RPC 1.8(f) prohibits funding arrangements by a non-client for legal services without the client's consent, prohibiting interference with the lawyer's independent professional judgment while preserving client confidentiality.

Lawyers also have a fiduciary duty to their clients that cannot be interfered with, including by PE managers, PE investors, or fund created entities. While such interests may not always collide, they are not dependent on each other.

Emerging Exceptions: Non-traditional Ownership Models in Select States

Several state jurisdictions have begun to experiment with loosening traditional regulatory restrictions on the corporate practice of law.

For example, Utah, through a regulatory sandbox established and overseen by its Supreme Court, permits non-traditional legal service providers and ownership structures on a pilot basis subject to ongoing monitoring and data collection. Similarly, Arizona authorizes "alternative business structures," allowing nonlawyers to hold ownership interests in law firms with approval and oversight from the state's judicial

branch. Both states vest authority over the practice of law in the judiciary rather than the legislature, and their state Supreme Courts exercise primary regulatory control.

These models represent a significant departure from the traditional prohibition under New Jersey's RPC 5.4 but remain the exception rather than the rule, and their results remain preliminary and under evaluation. Early reporting from Utah indicates that the sandbox has expanded access to legal services without clear evidence of widespread consumer harm, though questions remain regarding long-term impacts on cost, quality, professional independence, and the role of investor influence in legal decision making.

Whether politics will play a role in the prevalence of PE remains to be seen. Utah and Arizona select their judges through a merit-based appointment process followed by non-partisan retention elections, raising questions as to how non-traditional ownership structures involving PE will fare under continued state judicial oversight.

These developments remain limited and experimental and do not signal a major departure from the prevailing reluctance to embrace PE partnerships.

In states such as New Jersey, for example, where an appointed judiciary maintains exclusive constitutional authority over the practice of law, courts continue to strictly enforce corporate practice restrictions. Therefore, law firms and PE partnerships should not rely on emerging models in other states and instead should carefully structure operations in compliance with existing prohibitions.

Conclusion: The Future of Private Equity in the Legal Industry

Whether PE will be attractive to law firms in the age of artificial intelligence remains a question, as does the issue of whether networking or consolidation arrangements will better serve law firms and PE investors. For these arrangements to work, they will need to preserve the attorney-client relationship and the attorneys' duty to their clients and the judicial system.

If not, then the challenges associated with PE's entry into the healthcare sector could be repeated or even worsened with PE's entry into the practice of law. Law firms and investors should carefully evaluate both the opportunities and the structural constraints before pursuing such arrangements.

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