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The Newest Law Firm Partner: Private Equity

By Howard Rosenberg

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The war for partner talent among leading law firms is fiercer than ever. Eye-popping compensation packages for rainmakers are attracting attention even from the mainstream press. Among the elite in the Am Law rankings, firms have the firepower to offer lateral partners guarantees worth tens of millions of dollars without denting firm finances. But without large war chests, where most yearly profit is distributed rather than reinvested to keep existing partners content, the pressure for inorganic growth is broadly felt at large and midsize law firms. Flexible capital in the mold of private equity will become a key tool to empower more firms to compete.

Credit: Egor/Adobe Stock

Supercharged Lateral Hiring

Law firms traditionally expanded either slowly or quickly. The slow path entailed cultivating internal talent to prepare associates to become partners, sprinkled with opportunistic recruiting of individual lateral partners often thrown over the transom by a recruiter. The fast path was to merge with another firm.

Today, many firms prefer a new third option: lateral hiring at scale.

Hiring an entire group of laterals has several advantages. An individual lateral hire entails considerable guessing and risk as to whether the lateral will deliver the advertised book of business. But that risk is materially reduced by hiring a whole group of partners and associates servicing a valuable set of clients. If everyone moves, the odds shoot up that the book of business will follow. Among inorganic growth options, group hiring offers an attractive middle ground: faster than hiring one partner at a time, but more surgical than combining with an entire firm. CEOs and managing partners also like that this path keeps them in control — unlike a merger, which typically results in one of the managing partners departing or sidelined.

Even firms that don't aspire to expand rapidly face a growing imperative to succeed in the lateral marketplace. Rising lateral movement in the broader law firm sector creates more competitive threat and churn for virtually all firms. The frothy talent marketplace forces firms to make lateral hires merely to maintain a stable size. Management must play both offense and defense, in many cases upending their legacy compensation system or offering preemptive guarantees to the firm's existing rainmakers to stave off raids from a competitor's lateral hunting.

Finding the Money

The escalating need for capital required to lure new talent and simultaneously retain existing partners, all while operating costs continue to increase, is causing law firm management to take a hard look at their access to capital options. With assets that are largely their people, law firms lack plant, machinery, and real estate on the balance sheet to leverage as strategic assets. Asking current partners to fund an ambitious lateral hiring campaign often is a nonstarter. Law firm partnerships are not structured to make long-term investments, considering the different time horizons of their various individual members. Good luck convincing a partner who expects to retire in two years to fund an expensive investment projected to pay off over the next decade.

Plus, traditional bank lending, while ubiquitously available to firms, is also poorly suited to fund a law firm talent acquisition strategy. The returns on lateral hiring may well be lumpy, and the duration of the payback can be hard to project.

But what about more flexible financial sponsors pursuing a private equity-like return profile? With legal now firmly an identified asset class attracting outside investment, why not make law firm talent a new focus of opportunity?

Structuring a Talent Investment

Private equity investment into the legal asset class to date has principally focused everywhere except law firms — technology innovators, alternative legal service providers, consumer and online legal offerings, and consulting and outsourced-service companies, among others. For over a decade, initially around the edges and now firmly embedded, legal funders have created a $4.5 billion global pipeline allowing law firms to derisk their contentious case portfolios and this figure is forecasted to swell to $9.7 billion by 2032.

One need only look to the United Kingdom for where the market can turn. Unlike the United States, the UK has no restriction equivalent to American Bar Association Model Rule 5.4, which prohibits fee-sharing with non-lawyers. Significant investment into UK law firms is already happening. In one high-profile example from 2023, PE firm Inflexion bought out DWF, which had been the UK's largest publicly traded law firm. This followed the 2020 equity investment of legal funder Burford Capital, which took a 32% stake in PCB Litigation as part of an agreement to fund a portfolio of the firm›s matters.

But even in states where Rule 5.4 remains in effect, there presently exists a viable structure for law firm talent investing: management services organizations (MSOs). Traditionally associated with medical practices, MSOs are increasingly used across professional services contexts, including tax and accounting and the legal sector. In this model, the MSO entity can provide a range of support services to the associated professional entity in exchange for compensation. Investors in the MSO need not be licensed members of the relevant profession, but the professional entity remains wholly controlled by licensed professionals (in this case, attorneys). Financial structures for MSOs are deal specific and can include both debt and equity.

Flow of Funding

In terms of the actual flow of funding, Crispin Passmore, who advises investors and the legal market on regulatory structure at Stratify by Kingsley Napley writes, "There are several options for bringing PE money into a law firm. Debt models provide the PE firm an agreed coupon (interest payment). The debt can be convertible, for example if the regulatory situation of the firm changes to allow fee-sharing or non-lawyer ownership. But investors and firms can also use a range of structures to give the investor equity or an income stream that looks like equity but does not breach fee sharing bans. A PE-owned service company, following transfer pricing rules, provides one such option but new models are emerging based upon an Arizona ABS combined with a staffing business. In any case, investors are usually comfortable with minority stakes. Transnational law firms have even more flexibility."

One exciting feature of a talent investment deal would be the opportunity for current partners to co-invest. Not only would broad co-investment participation help to attract outside capital as a demonstration of partners' "skin in the game," but it also would have cultural benefits, unifying the partnership around a shared commitment to the firm's growth and future success. Moreover, co-investment would help to align incentives across partnership generations, as it would enable a senior partner to reap a share of future rewards even when they accrue beyond a partner's retirement. Such investment opportunities likewise could enhance "stickiness," with partners potentially less likely to jump to another competitor without weighing what investment upside they might leave behind in a move.

Appeal to Investors

It's easy to imagine why a law firm lacking the balance sheet to win talent battles might desire an infusion of capital to bolster its competitiveness. But why would this new focus on talent in the legal asset class appeal to investors? Scott Mozarsky, managing director at JEGI CLARITY, cites a confluence of factors.

First, regulatory changes and transactions in adjacent sectors have opened investors' eyes to law firms as an untapped market. "Arizona's decision to liberalize Rule 5.4 has been a catalyst for investors to take a harder look at the art of the possible relating to investments in law firms," said Mozarsky. "The recent wave of successful roll-ups in accounting and tax advisory, which have been executed using MSOs, has also been a strong driver. Investors are realizing that the law firm market is larger than they had imagined: it's a very profitable and scalable business that can benefit from pattern recognition and perspective of financial sponsors. And the multiple private equity-backed roll-ups in accounting, which has similar ethics and regulatory rules to the legal market, are highly relevant proxies." Mozarsky believes legal talent as an asset class would meet an investor base that is already primed to pursue legal sector deals.

Second, as compared to litigation finance opportunities currently available to institutional investors, legal talent could offer a less risky return profile. Rather than sharing in the return on a subset of a practice group's matters, a capital provider facilitating the hiring of a group would ultimately be able to benefit from the group's revenue pool as a whole. This has the potential to appeal to investors seeking a relatively more predictable, private equity-like return. In addition, legal talent investing would offer exposure not only to litigation but to transactional and regulatory practice areas as well.

The Path Ahead

Demand for capital to pursue legal talent might be concentrated initially among midsize firms—but that itself is a market exceeding $97 billion in revenue. In due course, just as has occurred with litigation funding in recent years, larger firms are likely to expand their talent with outside investment, although the best capitalized Am Law 100 firms may be the last to embrace this model.

Funding lateral hiring with external capital is likely to improve both hiring decisions and the rigor with which a hire's impact is calculated. "Most law firms do a poor job of tracking the actual costs of lateral partner hiring — there is not a tradition of accountability," explained law firm consultant Greg Jackson, a director at PwC in London. "External investors could be expected to ask hard questions instead of simply acquiescing to the firm's historical accounting practices. And current partners would be more motivated to engage on the strategy because the cost of funding lateral hires would become more visible to them."

Firms need capital to win the talent war, and investors stand ready to gain exposure to law firm profit streams. When will we be seeing regular news headlines in the press like "Premier PE firm X invests $50 million in law firm Y to help them build a world-class regulatory practice?" The time is ripe for talent investing in the legal asset class.

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