

Legal MSOs are private equity's new hot target!

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Long-held prohibitions requiring that only lawyers can own and control a law practice have largely blocked outsiders from investing in law firms historically. Most states still follow the rule that only a lawyer can own a law practice.

Despite these restrictions in many states, private equity and other outside investors are actively looking to invest in law firms nowadays. These outside investors are following the structure employed in the healthcare and accounting industries for some time, by forming management services companies to accomplish their goal of law firm investment.

Legal MSO model

A few jurisdictions have allowed non-lawyer ownership of law firms but most adhere to the corporate prohibition on the practice of law, similar to the corporate prohibition on the practice of medicine and of other professional occupations.

This rule requires that only lawyers can own interests in a law firm. Even those states that may allow non-lawyer ownership require that the lawyers still control the law practice itself. Since a non-professional cannot own and control the professional practice of the licensed attorneys, outside investors often employ a management services organization (MSO) to make their investment in a law firm.

With the legal MSO structure, non-lawyers can own interests in a management company, or services company, that acquires the non-professional, non-legal assets of the law practice and then manages the practice. This means that the MSO operates and manages the operational side of the business, such as providing administrative support, marketing, human resources and other non-legal tasks of the law firm.

It should not have a say in case or transaction management, work assignments, settlement decisions or discussions, hiring or termination of lawyers and/or other aspects of how the legal side of the business runs. The MSO often acts similar to a back office for the law firm, providing just these business and administrative functions for the law practice.

While the non-legal assets are held in the MSO entity, the professional or legal assets of the law practice must remain strictly owned and controlled by the licensed professionals in a separate professional entity. It is vitally important that the

professional and non-professional assets of the law practice remain separate and distinct.

Non-lawyers should not influence the lawyers in their professional decisions and practice considerations. If the non-lawyers impose their judgment and control on the lawyers, they risk being charged with the unauthorized practice of law. Public policy considerations have long set forth that the professional services of a lawyer should not be exploited or influenced by such outsiders, whether such outsiders be individuals or corporations.

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The MSO transaction itself involves documents that are similar to those seen by healthcare lawyers for quite a while, with the primary deal document being the acquisition agreement. This agreement usually takes the form of an asset purchase agreement.

In this agreement, the private equity buyer usually purchases all of the non-legal assets of the law firm. The agreement sets forth the purchase price, which is typically some initial consideration at closing and then often additional consideration paid upon achieving certain targets or practice goals.

In addition to the asset purchase agreement, the parties will usually prepare and negotiate a detailed management services agreement or services agreement. This agreement often is a long-term agreement designed to govern the relationship between the MSO and the professional law practice entity. It lays out the terms of that relationship and how it can be revised and/or terminated.

The management services agreement also sets forth the determination of the management fee and how it is calculated. It should also describe when this management fee is paid. This management services agreement should be carefully reviewed so that the power and control of the MSO over the business does not encroach on the professional practice of the law firm.

If the management company has the ability to control professional decision-making or otherwise infringes on the practice of law, it could run afoul of the ethical rules required of all attorneys.

Challenges facing legal MSOs

These offers to invest in law firms have some big differences from the healthcare transactions and other transactions many of us have handled that also utilize a MSO structure. Because lawyers cannot have non-competes imposed on them by most states, many of these deals have strict requirements on the law firm to make up for this risk the investors feel they are assuming.

Because they lack non-compete protections to control the professionals if the lawyers terminate or resign, these deals may have substantial liquidated damages provisions if lawyers do not continue to actively practice with the law firm or maintain certain productivity or financial targets of the law firm.

The outside investors believe these liquidated damages provisions are needed to offset their risk and align the lawyers with the long-term performance of the MSO entity. In such situations, the lawyers must be certain that they can achieve these targets and remain actively working or they could risk significant payment penalties.

These agreements may also set out other fees and costs that the law practice must pay to the MSO entity, which fees should be carefully examined to ensure the law firm can maintain profitability.

The management fee is another area of the deal requiring close attention to make certain it adheres to ethical and fee-splitting guidelines required of lawyers. Most states have Rules of Professional Conduct that strictly prohibit the sharing of legal fees.

The management company, however, charges a management or services fee to manage the non-legal assets of the firm. Therefore, this management fee also must be closely evaluated for legal and ethical compliance with the laws and rules applicable to the relevant jurisdiction.

Some states, like Arizona, have allowed non-lawyer ownership of law firms and use an alternative business structure, or ABS model, for law firm investment. Most states, however, still follow Model Rule 5.4 of the American Bar Association (ABA) Model Rules of Professional Conduct which prohibits fee sharing with nonlawyers. Since most states still largely follow Model Rule 5.4, they typically use the MSO model for investment, and not this ABS model.

It is important to note that some professionals are questioning private equity's foray into investing in another professional services area. For instance, Illinois recently introduced bills aimed at regulating private equity and hedge fund investments in MSOs involving law firms.

These laws are also looking at the fee involved in the legal MSO transactions and whether they violate professional fee splitting rules. These bills should continue to be monitored in Illinois as well as in other states to see if and how they may affect law firm investment going forward.

Benefits of outside management and new technology

Law firm management is increasingly complicated, and many lawyers welcome the opportunity to have outside professional managers run the non-legal side of the business of a law firm. Some law firms have been employing non-lawyers as CEOs or CFOs for some time, and they view this as a logical extension of that type of arrangement.

Another reason law firms are looking for outside investment is because of the high cost of running a law practice in today's world. Increasingly, the new technologies needed to operate document systems, legal research and professional practices are very expensive. They can require an infusion of significant capital to which a law firm may not have easy access.

With the advent of AI, law firm practice is rapidly changing and law firms need to invest in this new technology to keep up with these steady changes in the profession. Outside investors can give law practices the necessary capital to purchase the technology and software enhancements needed for AI and other applications that improve lawyer and overall law firm performance.

Because law firms may lack the capital required for these expensive improvements to their practice, private equity and outside investors can give them access to additional capital for making these investments in their practice, which are needed to stay competitive in the ever-changing legal field.

Exit potential

Another attractive aspect of outside investment in law firms is that it enables senior partners to have an exit or retirement pathway that is lucrative. If done correctly, it also allows for the successful transition of their practice and clients. Equity partners in law firms have never had a good exit or retirement path to capitalize on the businesses they have spent their lives building.

With outside investment and the legal MSO structure, these lawyers then often receive a lump sum payout for the sale of the practice, but they also hold an ownership stake in the management entity itself.

In addition to any amounts they receive in the initial purchase of their non-professional assets, this roll-over equity, as their

stake in the MSO is typically called, has the potential to grow exponentially over time as the private equity investor grows and adds additional law firms to its platform.

The growth of the platform could yield a significant multiple in any ultimate exit and garner for these law firm equity partners the proverbial, “second bite of the apple” presented by the lure of private equity investment.

Alignment from other non-equity lawyers

One critical piece of this acquisition analysis requires a look at the long-term prospects and talents of the law practice and its legal professionals.

Close scrutiny of the transaction documents, the management company structure and the management fee and other fees imposed on the lawyers and law practice are paramount to a successful sale.

Any law firm considering this type of transaction needs to ensure that it does not lose its most valuable asset, its lawyers, due to a sale to an outside, non-lawyer investor. Many associates approaching partnership had dreams of becoming a partner. Often these younger professionals took their job with an eye on being an owner one day and participating in the decision-making and profits of the practice.

When this expectation is no longer available to them, the firm risks these lawyers leaving to join other traditional law practices or starting their own practices. Any law firm considering this type of transaction should consider how this sale will affect these junior professionals. The senior partners may need to really persuade the other lawyers at the firm of the merits of this type of MSO transaction.

Additionally, the principals of the private equity buyer may also need to step in and further assuage the fears and concerns of the non-equity lawyers who are unfamiliar with this new structure. If the other lawyers do not agree with the structure, then the law firm risks losing their talent.

The law firm may need to consider elevating certain associates or income partners to equity partner positions prior to a sale to encourage them to stick around after the transaction closes and be invested in the model from the start.

This, however, could divert some of the consideration from the equity partners who originally stood to gain the whole amount

of the purchase price in the sale. It may also be necessary to pay certain key associates and non-equity partners bonuses to keep them aligned with the transaction and incentivize them to remain post-closing. Retention of the professionals is key to the long-term success and profitability of the legal MSO model.

Not just big law — The middle market

Much has been written recently about interest in law firm investment by non-lawyers, such as private equity and fund backed MSOs, but these articles have largely been reported with respect to outside investment interest in Big Law.

There is, however, also considerable interest in middle market law firm investment space that few are noticing. Now, middle-market law firms are being presented with offers from private equity looking to invest in their unique practices.

In my own practice, I am seeing considerable interest in investing in these types of law firms, such as boutique firms, malpractice firms and patent firms, all in this attractive middle market space. Outside managers see these middle market firms as places where they can improve profitability and increase operational efficiencies by the introduction of an outside professional manager.

These boutique firms also often are in need of the capital needed to implement AI and other technological improvements and efficiencies to their practice. These considerations are making the middle market and boutique law firms especially well-suited to take advantage of outside investment.

Opportunities abound

This uncharted territory of law firm investment is ripe with opportunity for law firms and outside investors.

Private equity is giving law firms an avenue for investment in new resources, like AI platforms, needed to stay relevant and competitive as well as providing them paths to monetize the businesses they have built over their careers. However, the uncertainty in this new area requires careful attention to the legal and ethical intricacies involved in any law firm acquisition, which varies from state to state.

Close scrutiny of the transaction documents, the management company structure and the management fee and other fees imposed on the lawyers and law practice are paramount to a successful sale. Each deal should be carefully reviewed for legal and ethical compliance with existing rules and regulations in each relevant jurisdiction.

What this outside investment in law firms will mean for the future of the law firm profession remains to be seen, but there is little doubt that this interest in law firm investment by private equity and others is here to stay!

About the author



Jonna Eimer is a shareholder at **Roetzel & Andress LPA**. She counsels licensed professionals, including lawyers, accountants, physicians, dentists, veterinarians on corporate governance, employment matters, and complex business transactions, including the formation of management services organizations (MSOs) and the structuring of transactions involving private equity. She can be reached at jeimer@ralaw.com.

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