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Exit Strategies: Think Like a Start-up

By Howard Cohl

One of the first questions a sophisticated investor considers when making a commitment to a start-up company is: How will I get out? If you don't believe me, just watch an episode of Shark Tank.

Whether businesses sell hard goods, license technology or dispense advice (*e.g.*, law firms), the common thread is that they are all businesses founded by one or more individuals, all of whom will someday exit the business. Law firms are businesses, and all too often partners and founders lose sight of that basic premise. Doing so can cost them dearly when it comes to building inherent value in the firm.

Building Value

Building value in any business is ultimately premised upon understanding your ultimate exit strategy — and the sooner you can wrap your head around that issue, the better. Usually, when people contemplate starting and running a business, they think about working capital, how to enhance sales and profit, and strategies to attract and retain talent. Yes, all very important items, indeed. And should this be the sum total of the strategic thinking, the end result may very well be a terrific business, albeit one that may have failed to maximize its intrinsic value. A past business partner and close friend of mine who was very involved in the venture capital and private equity world was fond of saying, "If you build a successful business but do so in such a way that there is no clear exit, you are building a business that is worth less than it is worth." The importance of the exit strategy was so near and dear to my friend's heart that we even had a book published on the subject many years ago titled, "What's Your Exit Strategy?" Many of the concepts in this article are derived from that book in which he and I collaborated.

What About Law Firms?

My colleagues and I at Major, Lindsey & Africa frequently come across law firms, especially boutiques, that are "worth less than they are worth" mainly because they entered the world of practicing law without giving any thought to how they would exit it. Fortunately for many of them, we have been able to guide their thinking toward building real value by helping them learn how to make day-to-day decisions with a long-term exit strategy in mind.

Of course, it is possible that if a law firm is successful enough, the value will come and the exit will take care of itself. Yet, to paraphrase Louis Pasteur, chance favors the prepared. Mind you,

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it's not just law firms that find themselves in this quandary, but nearly every service-sector enterprise that was established and built only with profit in mind, not value.

Law firms are unique structures in and of themselves and thus not all of the tried and true exit strategies of, say, the next generation of Silicon Valley start-ups are applicable. For example, law firms cannot go public (unless you happen to be in Australia) nor can they be owned by outside investors (unless you fall into a narrow exception in DC). Sorry, there goes the IPO or the sale to a private equity firm! Alas, the purpose of this article is not to plan for an exit strategy per se, but rather to offer ways to think in terms of building value via an understanding of the exit strategy process and to recognize how the exit strategy fits into day-to-day decision-making.

To start, let's briefly discuss five basic exit strategies that may be applicable to law firms:

1. Sale/Merger to a Strategic Acquirer

This is perhaps the most common exit strategy for a law firm. Here, the acquisition is done either to augment an existing business or strengthen the value of the whole, especially when the merger is of equals. Often, much can be gained simply by eliminating duplicative overhead, as the combined entity does not need two CFOs, two office managers, two separate billing systems, etc. More often, the real synergy comes by leveraging complementary practice areas in order to provide more services to clients, such as when a litigation shop merges with a corporate transaction boutique. A strategic acquirer can benefit from both the intrinsic value and specific synergies that result from the transaction.

The key to being an attractive merger candidate is advance planning and viewing the possibility of a future merger from "day one." When my aforementioned friend was with Philip Morris many years ago, the company acquired Clark Chewing Gum and built a beautiful new manufacturing plant. After several years, they decided to sell the company. However, they couldn't sell the business for the optimal amount. Why? Because they built their new chewing gum manufacturing plant smack dab in the center of their existing tobacco facility and integrated all their cigarette logistics into the new plant. This same general thinking by analogy holds true with law firms. Imagine thinking about the type of firm you want to merge with but then realizing your clients are all in conflict.

While you are formulating the type of firm you want to build is the ideal time to think about mergers, not when you are already fully grown. If a merger is your preferred exit, start thinking today about possible suitors, begin to recognize their needs, identify their gaps and build your practice accordingly. Be wary about "building your manufacturing plant in an area that no one else can use."

2. Employee Sale

Selling a business to trusted employees occurs frequently, especially with small law firms. Employee sales are often unique in one key respect: While the buyers have an intimate understanding of the business and its value, they typically lack the capital to make an outright acquisition. As a result, the owners usually need to be a bit more creative in structuring their compensation to be paid out over time and out of profits from the firm. We see this frequently with law firms where the founders have simply had

enough and had the forethought to groom a successor in whom they have confidence to be successful.

3. *Dissolve Slowly*

Sometimes, the sum of a business is not more valuable than the parts, and like a used car, the "parts" are sold off piecemeal from time to time until there is nothing left. While it is possible a law firm could sell off practice groups one at time to other firms, it is rather unlikely. So, for purposes of this article, we'll lump this strategy with going public and selling to a financial buyer and forget about it.

4. *Take It to the Grave*

Many people simply plan on working until they die, or rather, they end up working until they die because they had not developed any other plan. Nothing wrong with this strategy when planned — and hopefully far enough in advance so that employees and family members are not left in the lurch come judgment day. I recently came across a seasoned employee benefits practitioner who founded his firm when ERISA was a new practice area. As the sole shareholder, he built a solid reputation and nice cash-flowing business. Now, up in years with a diminishing albeit profitable practice and no identified successor in place, he's left with a business that is most likely "worth less than it is worth."

5. *Shut the Doors*

Clearly, shutting the doors of a practice is the exception to the general rule that exits are best planned, but reality can be harsh at times. No one goes into business with the dream of shutting down. As Mike Tyson said, "Everyone has a plan until they get punched in the mouth." The recent example of the Burleson Law Firm is a prime example. As extensively covered in the trades, it was reported that its $20 million business couldn't support its $40 million infrastructure. In those instances, the exit strategy becomes one of shutting the doors and salvaging as much as possible, be it assets, goodwill, reputation, etc. I've included this as a strategy to illustrate two points: 1) just because the Grim Reaper comes knocking doesn't necessarily mean that all value goes up in smoke; and 2) exit strategies can evolve and change over time—voluntarily and involuntarily; they have to be reviewed frequently.

Granted, not all exit strategies apply to all instances. There are dramatic differences between boutique firms and, say, the AmLaw 100. But for the balance of this article, with the essential exit strategies now on the table, let's focus on those most applicable to boutique law firms — 1) merger; 2) sell to an employee; and 3) take it to the grave — and take a look at how these three exit strategies can impact day-to-day decision-making with respect to driving revenue and hiring.

Bear in mind that the exit strategy decision process is, to a high degree, guided by preference and personality. Some people want to just work for themselves and not answer to anyone. Others want to build something big and lasting. Others want simply to make money. And others really take pride in creating jobs for others. Once you know what drives you to get up in the morning, the exit strategy thought process ought to become more apparent.

Driving Revenue

Of course, every firm needs to enhance revenue. But the question is, at what cost? To limit the variables, let's assume a boutique, single shareholder firm with a management-side labor and

employment practice and a $4 million book of business. Imagine an opportunity arises to take on employee clients that will bring in an additional $1 million in business each year. Assuming there is no inherent conflict between the two, do she and her colleagues take them? Here's how an understanding of the exit strategy can help in the decision-making process.

If the decision is to work until she drops, then there is not much downside in taking on the clients, and she'll have brought in an extra $1 million in gross revenue each year.

If the ideal exit down the road is to merge with a major specialty labor and employment firm representing management and leverage the larger platform to grow substantially the management-side billings, then problems could arise. Will a boutique firm with clients on "both sides of the fence" even be attractive to a larger specialty suitor? In this scenario, the putatively valued "$5 million" practice might not be of interest to a major management-side labor firm because of the potential conflicts. Even if the employee clients could be jettisoned, it may not be worth the trouble. In other words, the firm may end up being worth less than it is worth. And so, because of the shortsighted view, the opportunity for the merger could be lost. Short-term gains constantly need to be measured against long-term opportunity and value.

Hiring

Assume now that our boutique firm single shareholder decides to bring on a partner of similar age. It is imperative during the courting process that both parties are on the same page of the exit strategy playbook. If they are not, they could be headed for real disaster. Imagine if one has the preconceived notion of merging with an AmLaw 200 firm, and the other does not. Internal disagreements among partners are often as unattractive to potential suitors as are the conflicting clients mentioned in the example above.

And what if our sole shareholder desires to annoint a younger associate with the notion of selling the firm to him at some point down the road? Terrific if he's on board with that strategy. But what if that was never his dream? Our shareholder may be setting herself up for major disappointment and ultimately a firm that is worth less than it is worth.

So what are the takeaways? First, give advance thought to your exit strategy. If you haven't already contemplated your exit, start thinking about it today and seek independent guidance and counsel. Second, be sure everyone in your firm is on the same page with that strategy. Your firm's long-term value depends on it. Finally, be sure to match your exit strategy goals with your major decisions, especially as they relate to client generation and hiring.

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