Valuing Your Medical Practice

How to Avoid Dangerous Traps and Pitfalls

Published in MDNetGuide July 2006

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In the last issue of MDNet Guide I discussed some of the issues associated with determining the amount of spousal support which might be awarded in a divorce. Now let's look at how a medical practice is valued and the hidden pitfalls which can produce unintended and dramatic financial consequences for the unwary.

Valuing Assets

Stated broadly, property accumulated during a marriage is valued and divided in some fashion in the case of a divorce. Some states require an "equal" division while others impose an "equitable" division (which may be greater or less than half, depending on all the circumstances). Certain assets, such as publicly traded stocks, mutual funds and retirement plans are easy to value and can usually be divided without much difficulty. Real estate may present valuation problems because each property is unique, to some extent, so appraisals and expert testimony may be necessary.

Determining the proper value for a medical practice is often a subject of heated litigation. There have been many appellate court decisions and countless trials over the issue of the "proper" manner and amount to be used in calculating a value for the practice. However it is reached, the value is then divided as community or marital property with the professional spouse paying the non-professional spouse with cash or other assets. Although the law may vary significantly from one state to another I'll try to lay out some general guidelines, but make sure you check with a local attorney to see how the rules apply in your circumstance.

Real Estate

Computing the value first involves adding up the hard, tangible assets such as real estate, equipment, furnishings and supplies used in the practice. The term "value" that I've been using here refers to "Fair Market Value" which, for legal purposes generally refers to the price that a buyer would pay for the item without subtracting associated expenses such as taxes or selling costs. For example, if you can sell your medical office condo for $500,000, that's the value that will generally be used. An award of 50% to your spouse will be $250,000. This may not be a fair result since all of the taxes and expenses are then paid from your side of the ledger. For example, if taxes on the sale are $50,000 and commissions and other costs of sale are $30,000, you will wind up with $170,000 versus $250,000 for your spouse.

Accounts Receivable

A division of the value of accounts receivable may produce even more dramatic and unbalanced results. A client of mine had $500,000 of collectible accounts receivable. The obligation to her spouse would have been half of this or $250,000. Although her spouse would receive this amount by law, that's much more then my client would have received. We calculated that as she collected the $500,000 in the course of her practice she would have roughly $200,000 in office expenses and taxes. So, out of the original $500,000, she would have to pay $250,000 to her spouse and $200,000 in expenses-leaving her with a net of only $50,000. That's certainly not an equal division. Even if the receivables were to be valued after subtracting taxes, the associated office expenses would still have to be funded out of her share, creating a huge disparity in what each side gets.

Goodwill

The final step after these tangible assets are calculated is determining and adding in the so-called "goodwill" of the practice. The most common technique for valuing goodwill is known as the "excess earnings" approach, best explained by an example. In short, if the average cardiologist in your area earns $250,000 per year and you earn $350,000, the amount of the excess earnings is $100,000. That number is then multiplied by a "capitalization" of between one and five (depending on various factors) to arrive at the value of the goodwill in the practice. In this example, goodwill is some amount between $100,000 and $500,000

As a practical matter, since most practices cannot be sold and have no value apart from the services of the particular physician, there really is no goodwill value to be considered and divided. The real source of any "excess earnings" in your practice is the fact that you work harder than most; have greater skill or experience or a wider range of referral sources than other physicians in your specialty. As obvious as this may be to you and me, goodwill is calculated in every medical practice and the non-physician spouse is awarded his or her share of whatever value is determined.

Conclusion

Valuing a medical practice in the case of a divorce often creates a substantial windfall for the non-physician spouse. Assets of the practice such as real-estate, equipment, accounts receivable and goodwill are loaded with potential traps, producing unanticipated losses and obligations. Proper advance planning can usually ensure a more favorable and equitable outcome and as always, we recommend that you seek and rely on the advice of your experienced financial advisors.

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