MERGE HEALTHCARE INC
Form 10-Q
October 30, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2009

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 0–29486

MERGE HEALTHCARE INCORPORATED
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	39–1600938 (I. R. S. Employer Identification No.)

6737 West Washington Street, Suite 2250, Milwaukee, Wisconsin 53214–5650
(Address of principal executive offices, including zip code)

(Registrant's telephone number, including area code) (414) 977–4000

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of "accelerated filers", "large accelerated filer" and "smaller reporting company" in Rule 12b–2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer x	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b–2 of the Act). Yes o No x

The number of shares outstanding of the Registrant's common stock, par value $0.01 per share, as of October 27, 2009: 66,134,385

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PART I – FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except for share data)

ASSETS	September 30, 2009 (Unaudited)	December 31, 2008
Current assets:		
Cash and cash equivalents, including restricted cash of $409 and $621 at September 30, 2009 and December 31, 2008, respectively	$ 16,883	$ 17,848
Accounts receivable, net of allowance for doubtful accounts and sales returns of $1,173 and $1,378 at September 30, 2009 and December 31, 2008, respectively	15,714	12,779
Inventory	377	550
Prepaid expenses	1,965	1,509
Deferred income taxes	217	217
Other current assets	3,002	721
Total current assets	38,158	33,624
Property and equipment:		
Computer equipment	8,189	6,317
Office equipment	2,414	1,989
Leasehold improvements	1,539	1,272
	12,142	9,578
Less accumulated depreciation	8,737	7,604
Net property and equipment	3,405	1,974
Purchased and developed software, net of accumulated amortization of $14,501 and $12,584 at September 30, 2009 and December 31, 2008, respectively	13,978	5,653
Customer relationships and trade names, net of accumulated amortization of $1,998 and $1,259 at September 30, 2009 and December 31, 2008, respectively	7,738	2,291
Goodwill	25,145	-
Deferred income taxes	4,585	4,585
Investments	528	5,690
Other assets	326	920
Total assets	$ 93,863	$ 54,737

LIABILITIES AND SHAREHOLDERS' EQUITY				
Current liabilities:				
Accounts payable	$	5,957	$	4,036
Accrued wages		1,933		1,590
Restructuring accrual		1,582		1,173
Note payable		14,623		-
Current portion of capital lease obligations		188		-
Other accrued liabilities		2,669		2,421
Deferred revenue		14,895		16,150
Total current liabilities		41,847		25,370
Note payable		-		14,230
Capital lease obligations, net of current portion		94		-
Deferred income taxes		39		39
Deferred revenue		1,622		644
Income taxes payable		5,461		5,418
Other		227		195
Total liabilities		49,290		45,896
Shareholders' equity:				
Series 3 Special Voting Preferred Stock, no par value: one share authorized; zero shares and one share issued and outstanding at September 30, 2009 and December 31, 2008		-		-
Common stock, $0.01 par value: 100,000,000 shares authorized: 65,647,793 shares and 55,506,702 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively		656		555
Common stock subscribed, 6,595 shares and 30,271 shares at September 30, 2009 and December 31, 2008, respectively		26		37
Additional paid-in capital		498,576		465,083
Accumulated deficit		(456,289)		(458,641)
Accumulated other comprehensive income		1,604		1,807
Total shareholders' equity		44,573		8,841
Total liabilities and shareholders' equity	$	93,863	$	54,737

See accompanying notes to unaudited condensed consolidated financial statements.

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MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except for share and per share data)

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Net sales:				
Software and other	$ 7,755	$ 7,398	$ 25,459	$ 19,733
Services and maintenance	9,152	7,218	22,110	21,941
Total net sales	16,907	14,616	47,569	41,674
Cost of sales:				
Software and other	600	1,314	2,710	3,842
Services and maintenance	3,402	2,528	7,925	9,471
Depreciation and amortization	899	742	2,172	2,174
Total cost of sales	4,901	4,584	12,807	15,487
Gross margin	12,006	10,032	34,762	26,187
Operating costs and expenses:				
Sales and marketing	2,470	1,824	5,968	7,497
Product research and development	2,689	2,931	7,503	11,151
General and administrative	3,616	3,483	8,972	18,093
Acquisition-related expenses	658	-	997	-
Trade name impairment, restructuring and other expenses	1,974	(205)	1,974	11,862
Depreciation, amortization and impairment	755	654	1,849	2,954
Total operating costs and expenses	12,162	8,687	27,263	51,557
Operating income (loss)	(156)	1,345	7,499	(25,370)
Other income (expense):				
Interest expense	(775)	(751)	(2,304)	(994)
Interest income	6	68	30	218
Other, net	18	35	(2,801)	430
Total other income (expense)	(751)	(648)	(5,075)	(346)
	(907)	697	2,424	(25,716)

Income (loss) before income taxes				
Income tax expense (benefit)	29	269	72	(115)
Net income (loss)	$ (936)	$ 428	$ 2,352	$ (25,601)
Net income (loss) per share - basic	$ (0.02)	$ 0.01	$ 0.04	$ (0.59)
Weighted average number of common shares outstanding - basic	61,077,637	56,171,905	57,904,467	43,496,189
Net income (loss) per share - diluted	$ (0.02)	$ 0.01	$ 0.04	$ (0.59)
Weighted average number of common shares outstanding - diluted	61,077,637	56,859,379	59,552,430	43,496,189

See accompanying notes to unaudited condensed consolidated financial statements.

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MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Nine Months Ended September 30, 2009	2008
Cash flows from operating activities:		
Net income (loss)	$ 2,352	$ (25,601)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation, amortization and impairment	4,021	5,128
Share-based compensation	1,256	3,836
Loss on disposal of subsidiary	-	1,665
Amortization of note payable issuance costs & discount	837	336
Loss on investment	3,624	-
Trade name impairment	-	1,060
Provision for doubtful accounts receivable and sales returns, net of recoveries	151	267
Deferred income taxes	-	(384)
Changes in operating assets and liabilities, net of effects of acquisitions and dispositions:		
Accounts receivable	2	868
Inventory	396	841
Prepaid expenses	349	(683)
Accounts payable	(2,404)	(3,035)
Accrued wages	(554)	52
Restructuring accrual	411	1,461
Deferred revenue	(6,189)	(2,883)
Other accrued liabilities	(373)	(196)
Other	588	231
Net cash provided by (used in) operating activities	4,467	(17,037)
Cash flows from investing activities:		
Cash paid for acquisitions, net of cash acquired	(1,752)	-
Proceeds from sale of subsidiary	-	413
Purchases of property, equipment, and leasehold improvements	(165)	(503)
Change in restricted cash	338	-

Proceeds from sale of equity investment		886			-	
Net cash used in investing activities		(693	)		(90	)
Cash flows from financing activities:						
Proceeds from issuance of term note, net of non-cash discount of $510		-			14,490	
Proceeds from issuance of Common Stock		-			5,479	
Note and stock issuance costs paid		-			(2,386	)
Proceeds from exercise of stock options and employee stock purchase plan		78			63	
Principal payments on notes		(4,570	)		-	
Principal payments in capital leases		(35	)		-	
Repurchase of Common Stock		-			(47	)
Dividends paid		-			(57	)
Net cash provided by (used in) financing activities		(4,527	)		17,542	
Effect of exchange rates on cash and cash equivalents		-			9	
Net increase (decrease) in cash and cash equivalents		(753	)		424	
Cash and cash equivalents (net of restricted cash), beginning of period (1)		17,227			13,637	
Cash and cash equivalents (net of restricted cash), end of period (2)	$	16,474		$	14,061	
Supplemental Disclosures of Cash Flow Information:						
Cash paid for interest	$	1,463		$	975	
Cash paid for income taxes, net of refunds	$	(173	)	$	17	

(1) Net of restricted cash of $621 and $363 at December 31, 2008 and 2007, respectively.

(2) Net of restricted cash of $409 and $363 at September 30, 2009 and 2008, respectively.

See accompanying notes to unaudited condensed consolidated financial statements.

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MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(Unaudited)
(in thousands, except for share and per share data)

	Preferred Stock		Common Stock							
	Shares Issued	Issued Amount	Shares Subscribed	Subscribed Amount	Shares Issued	Issued Amount	Additional Paid–in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance at December 31, 2008	1	$ -	30,271	$ 37	55,506,702	$ 555	$ 465,083	$ (458,641)	$ 1,807	$ 8,841
Exchange of exchangeable share rights into Common Stock	-	-	-	-	719,412	7	(7)	-	-	-
Retirement of preferred share	(1)	-	-	-	-	-	-	-	-	-
Stock issued under ESPP	-	-	(23,676)	(11)	56,830	1	88	-	-	78
Share-based compensation expense	-	-	-	-	-	-	1,256	-	-	1,256
Shares issued for acquisitions	-	-	-	-	9,364,849	93	32,156	-	-	32,249
Net income	-	-	-	-	-	-	-	2,352	-	2,352
Other comprehensive loss	-	-	-	-	-	-	-	-	(203)	(203)
Balance at September 30, 2009	-	$ -	6,595	$ 26	65,647,793	$ 656	$ 498,576	$ (456,289)	$ 1,604	$ 44,573

See accompanying notes to unaudited condensed consolidated financial statements.

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MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Net income (loss)	$ (936)	$ 428	$ 2,352	$ (25,601)
Translation adjustment	-	-	-	283
Unrealized loss on marketable security	(37)	(368)	(203)	(848)
Comprehensive net income (loss)	$ (973)	$ 60	$ 2,149	$ (26,166)

See accompanying notes to unaudited condensed consolidated financial statements.

Merge Healthcare Incorporated and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited and in thousands, except for share and per share data)

(1) Basis of Presentation and Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") for reporting on Form 10-Q. Accordingly, certain information and notes required by United States of America generally accepted accounting principles ("GAAP") for annual financial statements are not included herein. These interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2008 of Merge Healthcare Incorporated, a Delaware corporation, and its subsidiaries and affiliates (which we sometimes refer to collectively as "Merge," "we," "us" or "our").

Principles of Consolidation

Our unaudited condensed consolidated financial statements reflect all adjustments, which are, in the opinion of management, necessary for a fair presentation of our financial position and results of operations. Such adjustments are of a normal recurring nature, unless otherwise noted. The results of operations for the three and nine month periods ended September 30, 2009 are not necessarily indicative of the results to be expected for any future period.

Our unaudited condensed consolidated financial statements are prepared in accordance with GAAP. These accounting principles require us to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We believe that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. Actual results could differ materially from those estimates.

Our unaudited condensed consolidated financial statements include the results of etrials Worldwide, Inc. ("etrials") since July 20, 2009, and the results of Confirma, Inc. ("Confirma") since September 1, 2009.

Reclassifications

Where appropriate, certain reclassifications have been made to the prior periods' financial statements to conform to the current year presentation. Specifically, we have reclassified $649 of certain accrued expenses from other current liabilities to accounts payable in the balance sheet as of December 31, 2008 in order to conform to current year presentation.

(2) Significant Acquisitions

etrials Worldwide, Inc.

On July 20, 2009, we completed the acquisition of etrials, a provider of clinical trials software and services to pharmaceutical, biotechnology, medical device, and contract research organizations. The transaction was announced on June 1, 2009, upon the execution of a definitive agreement, and closed on July 20, 2009. Under the terms of the Merger Agreement, we acquired all of the outstanding shares of common stock of etrials for consideration per share of $0.80 in cash, without interest, and 0.3448 shares of Merge Common Stock. Upon completion of the acquisition, we renamed this entity Merge eClinical. Our condensed consolidated statements of operations include etrials sales of $2,420 and net loss of $577 for the period July 20, 2009 through September 30, 2009.

Reasons for the Transaction

Our acquisition of etrials will allow us to create an organization capable of providing clinical trial sponsors and contract research organizations ("CROs") comprehensive and configurable solutions that integrate critical imaging technologies with electronic eclinical capabilities to address the needs of all the stakeholders in clinical trials utilizing imaging.

Purchase Accounting

The transaction consideration was valued at approximately $25,077, including the exchange of 3,942,732 shares at a market price of $4.04 per share, and $9,149 in cash. The fair value of stock issued was based upon the NASDAQ closing price of our stock on July 20, 2009. The acquisition was accounted for using the purchase method of accounting. Merge was considered the accounting acquirer, requiring the purchase consideration to be allocated to etrials' net tangible and intangible assets based on their respective fair values as of the closing date, with the residual reflected as goodwill. The allocation of the purchase consideration is preliminary and based upon estimates made by us with the assistance of independent valuation specialists. The estimated purchase price allocation, based on etrials' assets and liabilities as of July 20, 2009, was as follows:

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Merge Healthcare Incorporated and Subsidiaries
Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands, except for share and per share data)

	Estimated Fair Value
Cash	$ 6,077
Other tangible assets	4,565
Liabilities assumed	(5,215)
Purchased and developed software	3,950
Customer relationships	2,640
In-process research and development	760
Trade names	270
Goodwill	12,030
Total consideration	$ 25,077

The amounts allocated to purchased and developed software, customer relationships, trade names and in-process research and development ("IPR&D") are preliminary and estimated by us based on the work performed by independent valuation specialists, primarily through the use of discounted cash flow techniques. Appraisal assumptions utilized under these methods include a forecast of estimated future net cash flows, as well as discounting the future net cash flows to their present value. Acquired intangible assets are being amortized over the estimated useful lives as set forth in the following table:

	Years
Proprietary technology	7.0
Customer relationships	10.0
Trade names	6.0
IPR&D	-
Goodwill	Indefinite

The estimated asset lives are determined based on projected future economic benefits and expected life cycles of the acquired intangible assets. The value assigned to IPR&D will not be amortized until the completion or abandonment of the associated research and development efforts.

The value assigned to acquired in-process research and development is determined by identifying the acquired specific in-process research and development projects that will be continued, and for which (1) technological feasibility has not been established at the acquisition date, (2) there is no alternative future use, and (3) the fair value is estimable with reasonable reliability. The nature of the efforts to develop the in-process technology into the commercially viable products is expected to principally relate to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the technology can be produced to meet its design specification, including function, features and technical performance requirements. At the date of the business combination, etrials had an in-process project meeting the above criteria involving an electronic data capture ("EDC") platform.

The amount assigned to goodwill is not being amortized, but will be tested for impairment annually or under certain circumstances that may indicate a potential impairment. The $12,030 assigned to goodwill will not be deductible for federal income tax purposes.

Confirma, Inc.

On September 1, 2009, we completed the acquisition of Confirma, a provider of computer systems for processing and presentation of data from magnetic resonance imaging (“MRI”) studies. The transaction was announced on August 7, 2009, upon the execution of a definitive agreement, and closed on September 1, 2009. Under the terms of the Merger Agreement, we acquired all outstanding shares of Confirma in exchange for 5,422,104 shares of Merge Common Stock. Upon completion of the acquisition, we renamed this entity Merge CAD. Our condensed consolidated statements of operations include Confirma sales of $612 and net loss of $1,005 for the period September 1, 2009 through September 30, 2009.

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Merge Healthcare Incorporated and Subsidiaries
Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands, except for share and per share data)

Reasons for the Transaction

Our acquisition of Confirma creates an organization providing advanced applications for visualization and analysis of MRI studies that has the capability to widen the global adoption of this type of technology through Merge's international distribution network.

Purchase Accounting

The transaction consideration was valued at approximately $16,231, including the exchange of 5,422,104 shares at a market price of $3.01 per share, of which 46,628 shares were placed in escrow. The estimated transaction consideration excludes $89 for claims against the escrow. The fair value of stock issued was based upon the NASDAQ closing price of our stock on September 1, 2009. The acquisition was accounted for using the purchase method of accounting. Merge was considered the accounting acquirer, requiring the purchase consideration to be allocated to Confirma's net tangible and intangible assets based on their respective fair values as of the closing date, with the residual reflected as goodwill. The allocation of the purchase consideration is preliminary and based upon estimates made by us with the assistance of independent valuation specialists. The estimated purchase price allocation, based on Confirma's assets and liabilities as of September 1, 2009, was as follows:

	Estimated Fair Value
Cash	$ 2,696
Other tangible assets	3,507
Liabilities assumed	(9,717)
Purchased and developed software	5,300
Customer relationships	2,800
Trade names	300
Goodwill	11,345
Total consideration	$ 16,231

The amounts allocated to purchased and developed software, customer relationships and trade names were estimated by us based on the work performed by independent valuation specialists, primarily through the use of discounted cash flow techniques. Appraisal assumptions utilized under these methods include a forecast of estimated future net cash flows, as well as discounting the future net cash flows to their present value. Acquired intangible assets are being amortized over the estimated useful lives as set forth in the following table:

	Years
Proprietary Technology	5.3
Customer Relationships	9.5
Trade Names	10.0
Goodwill	Indefinite

The estimated asset lives are determined based on projected future economic benefits and expected life cycles of the acquired intangible assets. The amount assigned to goodwill is not being amortized, but will be tested for impairment annually or under certain circumstances that may indicate a potential impairment. The $11,345 assigned to goodwill will not be deductible for federal income tax purposes.

Pro forma Results

As discussed in Note 1, the results of etrials have been included in our condensed consolidated financial statements since July 20, 2009, and the results of Confirma have been included since September 1, 2009.

The following unaudited pro forma condensed combined results of operations for the three and nine months ended September 30, 2009 and 2008, respectively, are based on the historical financial statements of Merge, etrials and Confirma giving effect to the business combination as if it had occurred at the beginning of the periods presented. Therefore, this pro forma data has been adjusted to exclude pre-acquisition intangible amortization, share-based compensation and warrant expense of etrials and Confirma, while including amortization of intangible assets during the entire applicable periods. This data also reflects only the historical Merge, etrials and Confirma tax expense. This data is not necessarily indicative of the results of operations that would have been generated if the transaction had occurred at the beginning of the respective periods. Moreover, this data is not intended to be indicative of future results of operations.

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Merge Healthcare Incorporated and Subsidiaries
Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands, except for share and per share data)

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008
Revenue	$ 19,584	$ 22,231
Net loss	(3,011)	(5,690)
Loss per share:		
Basic	$ (0.05)	$ (0.09)
Diluted	$ (0.05)	$ (0.09)

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Revenue	$ 64,679	$ 67,199
Net loss	(1,593)	(40,953)
Loss per share:		
Basic	$ (0.02)	$ (0.77)
Diluted	$ (0.02)	$ (0.77)

(3) Intangible Assets

Goodwill is our primary intangible asset not subject to amortization. The changes in carrying amount of goodwill by segment (as further discussed in Note 13) for the nine months ended September 30, 2009, are as follows:

	Indirect	Direct	Total
Balance at January 1, 2009	$ -	$ -	$ -
Goodwill due to etrials acquisition	-	12,030	12,030
Goodwill due to Confirma acquisition	11,345	-	11,345
Goodwill due to insignificant acquisitions	-	1,770	1,770
Balance at September 30, 2009	$ 11,345	$ 13,800	$ 25,145

Other than capitalized software development costs, our intangible assets subject to amortization are summarized as of September 30, 2009 as follows:

	Weighted Average Remaining Amortization Period (Years)	Gross Carrying Amount	Accumulated Amortization

Purchased software	5.0	$ 21,064	$ (8,508)
Customer relationships	7.7	9,166	(1,988)
Trade names	8.0	570	(10)
Total		$ 30,800	$ (10,506)

The estimated asset lives are determined based on projected future economic benefits and expected life cycles of the purchased software and customer relationships. The gross carrying amounts of purchased software include $760 of IPR&D that is not subject to amortization until completed.

Amortization expense for purchased software, which is being expensed within cost of sales on a ratable basis over the life of the related intangible asset, was $665 and $529 in the three months ended September 30, 2009 and 2008, respectively, and $1,620 and $1,589 in the nine months ended September 30, 2009 and 2008, respectively. Customer relationships and trade names amortization expense, which is being expensed in the depreciation, amortization and impairment classification of operating costs and expenses on a ratable basis over the life of the related intangible asset, was $329 and $245 in the three months ended September 30, 2009 and 2008, respectively, and $813 and $763 in the nine months ended September 30, 2009 and 2008, respectively.

In the three months ended September 30, 2009, we increased the gross carrying amount of purchased software, customer relationships and trade names by $10,010, $5,440 and $570, respectively, upon completion of the acquisitions of etrials and Confirma. In the nine months ended September 30, 2009, we increased the gross carrying amount of purchased software, customer relationships and trade names by $10,400, $5,690 and $570, respectively.

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Merge Healthcare Incorporated and Subsidiaries
Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands, except for share and per share data)

The estimated future amortization expense of purchased software (excluding IPR&D), customer relationships and trade names as of September 30, 2009 is as follows:

For the remaining 3 months of the year ended:	2009	$1,286
For the year ended December 31:	2010	5,145
	2011	3,497
	2012	2,320
	2013	2,320
	2014	2,229
	Thereafter	3,498

As of September 30, 2009, we had gross capitalized software development costs of $6,655 and accumulated amortization of $5,993. The weighted average remaining amortization period of capitalized software development costs was 1.2 years as of September 30, 2009. Capitalized software development amortization expensed within cost of sales was $137 and $213 in the three months ended September 30, 2009 and 2008, respectively, and $455 and $585 in the nine months ended September 30, 2009 and 2008, respectively.

In the nine months ended September 30, 2009, we received cash proceeds of $510 from the sale of patents which we determined were not necessary to support our business.

(4) Fair Value Measurement

We use a three-tier value hierarchy to prioritize the inputs used in measuring fair value of our financial assets and liabilities. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore, requiring us to develop our own assumptions.

We also consider additional information in estimating fair value when the volume and level of activity for the asset or liability have significantly decreased, or circumstances indicate a transaction is not suitable for fair value measurement. We disclose the required information about fair value of financial instruments in our interim financial statements as well as in our annual financial statements.

Non-Current Investments

At September 30, 2009, we held securities in a publicly traded entity valued at $115 and private companies valued at $413, which are classified as non-current assets. In determining fair value, we utilize techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. In calculating potential impairment losses for the private company securities, we evaluate the fair value of these investments by comparing them to certain public company metrics such as revenue multiples, independent transactions involving such securities, and inquiries and estimates made by us. The following tables set forth our non-current investments that are carried at fair value:

	Level 1	Level 2	Level 3	Balance at September 30, 2009
Investment in publicly traded equity security	$ 115	$ -	$ -	$ 115
Investments in equity securities of private companies	-	-	413	413
Total	$ 115	$ -	$ 413	$ 528

	Level 1	Level 2	Level 3	Balance at December 31, 2008
Investment in publicly traded equity security	$ 318	$ -	$ -	$ 318
Investments in equity securities of private companies	-	-	5,372	5,372
Total	$ 318	$ -	$ 5,372	$ 5,690

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Merge Healthcare Incorporated and Subsidiaries
Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands, except for share and per share data)

We performed the evaluation of our Level 3 investments in the quarterly period ended September 30, 2009, and concluded that there was no significant change in their fair value. Due to the acquisition of Eklin Medical Systems, Inc. ("Eklin") by VCA Antech, Inc. ("VCA") in July 2009, we sold our equity investment in Eklin for proceeds of $1,335. We received cash of $886 in the third quarter of 2009, with the remaining balance of $449 being held in an escrow account for up to two years to satisfy any remaining obligations which may arise from the transaction. We have recorded an impairment charge of $3,624 in the nine months ended September 30, 2009 related to the impairment of our investment in Eklin. The impairment charge is included in the other, net line of our condensed consolidated statement of operations. The following table sets forth the change in the fair value of our Level 3 non-current investments:

	Nine Months Ended September 30,	
	2009	2008
Balance at January 1	$ 5,372	$ 6,030
Transfer in	-	-
Sale of investment	(1,335)	-
Impairment charge	(3,624)	-
Balance at September 30	$ 413	$ 6,030

Unrealized gains or losses on our available-for-sale (publicly traded) security, as well as foreign currency translation adjustments, are components of accumulated other comprehensive income as set forth in the following table:

	Balance at September 30, 2009
Cumulative translation adjustment	$ 1,936
Net unrealized loss on available-for-sale security	(332)
Total accumulated other comprehensive income	$ 1,604

Other Financial Instruments

Our other financial instruments include cash and cash equivalents, accounts receivable, accounts payable, deferred revenue, note payable and certain accrued liabilities. The carrying amounts of these assets and liabilities approximate fair value due to the short maturity of these instruments and, in the case of the note payable, due to the interest rate and terms approximating those available to us for similar obligations.

(5) Debt, Capital Leases and Operating Leases

On June 4, 2008, we completed a private placement pursuant to which we raised net proceeds of $16,639 through a transaction with Merrick RIS, LLC (“Merrick”), an affiliate of Merrick Ventures, LLC ("Merrick Ventures"), which was executed on May 21, 2008. Based on the terms of the private placement, we received $20,000 from Merrick in exchange for a $15,000 senior secured term note due June 4, 2010 and 21,085,715 shares of our Common Stock. The note bears interest at 13.0% per annum, payable quarterly in arrears on the fourth day of March, June, September and December. Michael W. Ferro, Jr. and trusts for the benefit of Mr. Ferro’s family members beneficially own a majority of the equity interest in Merrick Ventures. Mr. Ferro, who is the chairman of our board of directors, also serves as the chairman and chief executive officer of Merrick Ventures. Accordingly, Mr. Ferro indirectly owns or controls the term note and all of the shares owned by Merrick. As of September 30, 2009, Merrick and its affiliates owned approximately 42.7% of our Common Stock. We paid interest to Merrick of $488 and $1,463 in the three and nine months ended September 30, 2009, respectively. We paid interest to Merrick of zero and $975 in the three and nine months ended September 30, 2008, respectively, including $975 of prepaid interest on the date we completed the transaction with Merrick. As of September 30, 2009 and December 31, 2008, we have recorded $163, or one month of accrued interest on the note, in other accrued liabilities. The note payable is classified as a short term liability at September 30, 2009, since it is due in June of 2010.

We assumed debt of $1,770 and $2,800, respectively, upon completion of our acquisitions of etrials and Confirma. These balances were repaid in full in the third quarter of 2009.

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We also assumed certain capital lease obligations associated with the acquisitions. As of September 30, 2009, the remaining obligations under these capital leases totaled $282. Equipment acquired under these capital leases had a cost of $428 and accumulated depreciation of $40 at September 30, 2009. Amortization expense related to equipment acquired under capital leases was $38 for the three and nine months ended September 30, 2009, and is included in the depreciation, amortization and impairment line of operating costs and expenses in our condensed consolidated statement of operations.

Payments due under our debt and capital lease obligations are set forth in the following table for the periods indicated:

		Note Payable	Capital Leases	Total
For the remaining 3 months of the year ended:	2009	$ -	$ 56	$ 56
For the year ended December 31:	2010	15,000	195	15,195
	2011	-	61	61
	2012	-	-	-
	2013	-	-	-
		$ 15,000	312	$ 15,312
Less: Amount representing interest			30	
Present value of future minimum lease payments			282	
Less: Current portion of capital lease obligation			188	
Capital lease obligation, net of current portion			$ 94	

In the third quarter of 2009, we entered into a new 10-year lease in Mississauga, Ontario, Canada to replace the existing lease which expires December 31, 2009. We will begin occupancy of the new leased space in the fourth quarter of 2009, which will reduce our rentable area to approximately 24,000 square feet. We also entered into a new 7-year lease in our Morrisville, North Carolina location, which is the primary location of etrials. This new lease reduces our rentable area to approximately 15,000 square feet. In addition, we abandoned approximately 5,000 square feet of leased space in our Bellevue, Washington facility, which is the primary location of Confirma. As a result of this action, we recorded a charge of $255 in the trade name impairment, restructuring and other line of our statement of operations in the third quarter of 2009.

Future minimum lease payments under all of our non–cancelable operating leases are set forth in the following table:

		Operating Leases
For the remaining 3 months of the year ended:	2009	$ 727
For the year ended December 31:	2010	1,924

2011	1,687
2012	894
2013	859
2014	807
thereafter	3,556

(6) Other Transactions with Related Party

Effective January 1, 2009, we entered into a consulting agreement with Merrick under which we receive certain consulting services for cash consideration of $100 per quarter, plus reasonable expenses, for a one year term. We paid $105 and $335 to Merrick for such services in the three and nine months ended September 30, 2009, respectively, and recognized $122 and $357 in expense within the general and administrative expense classification of operating costs and expenses in the three and nine months ended September 30, 2009, respectively. As of September 30, 2009, we have $22 recorded in accounts payable covering obligations under this agreement.

As a result of work performed related to our acquisitions of etrials and Confirma, we paid Merrick a success fee of $200 and expensed such amount within the acquisition related expense classification of operating costs and expenses in the three months ended September 30, 2009.

On March 31, 2009, we entered into a value added reseller agreement with Merrick Healthcare Solutions, LLC ("Merrick Healthcare"). Under terms of the agreement, Merrick Healthcare purchased software licenses from us for $400. Payment of the entire balance was made on the date of the agreement. We recognized $400 in revenue in the first quarter of 2009 related to this transaction.

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(7) Shareholders' Equity

Exchangeable Shares

As part of our business combination with Cedara Software Corp. in June 2005, we issued 5,581,517 shares of our Common Stock to the shareholders of Cedara Software Corp. and granted rights for the issuance of 13,210,168 shares of Common Stock to holders of Cedara Software Corp. exchangeable shares on a one-for-one basis. On February 13, 2009, we exercised our call right regarding redemption of the outstanding exchangeable shares, as certain conditions allowing us to do so were met. Final redemption occurred on April 15, 2009, and the exchangeable shares were delisted from the Toronto Stock Exchange following the close of trading on April 16, 2009. The respective weighted average number of these shares has been included within the number of shares of Common Stock used to calculate basic net income (loss) per share (see Note 12).

(8) Share-Based Compensation

The following table summarizes share-based compensation expense recognized during the periods indicated:

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Share-based compensation expense included in the statement of operations:				
Services and maintenance (cost of sales)	$ 8	$ 4	$ 37	$ 70
Sales and marketing	91	(19)	275	363
Product research and development	79	72	249	304
General and administrative	193	245	695	1,129
Trade name impairment, restructuring and other expenses	-	-	-	1,970
Total	$ 371	$ 302	$ 1,256	$ 3,836

Stock option activity in the nine months ended September 30, 2009 is set forth in the following table:

	Number of Options
Options outstanding, December 31, 2008	4,696,574
Options granted	375,000
Options exercised	-
Options forfeited and expired	(218,461)
Options outstanding, September 30, 2009	4,853,113

Options exercisable, September 30, 2009	1,941,805

There was no restricted stock award activity in the nine months ended September 30, 2009. There were 479,997 shares of restricted stock outstanding as of September 30, 2009.

As of September 30, 2009, there was approximately $2,859 of unrecognized compensation cost related to stock options and restricted stock that may be recognized in future periods.

(9)   Commitments and Contingencies

On April 27, 2006, Merge Healthcare received an informal, non-public inquiry from the Securities and Exchange Commission (“SEC”) requesting voluntary production of documents and other information. The inquiry principally related to our announcement, on March 17, 2006, that we would investigate allegations of improprieties related to financial reporting and revise our results of operations for the fiscal quarters ended June 30, 2005, and September 30, 2005. On July 10, 2007, SEC Staff advised us that the SEC had issued a formal order of investigation in this matter. Merge Healthcare is cooperating fully with the SEC. The SEC Staff has informed Merge Healthcare that the Staff is considering recommending an injunctive or cease and desist order against Merge Healthcare prohibiting violations of the reporting, record-keeping, and internal control provisions under the Securities Exchange Act of 1934. The Staff did not inform Merge Healthcare that it is considering recommending any monetary sanctions against Merge Healthcare. However, the matter has not yet been finally resolved, and, until such final resolution, Merge Healthcare will continue to incur expenses, including legal fees and other costs, in connection with the SEC’s investigation.

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On June 1, 2009, Merge Healthcare was served with a Summons and Complaint in the Milwaukee County Circuit Court, State of Wisconsin, captioned William C. Mortimore and David M. Nosay v. Merge Technologies Inc. n/k/a Merge Healthcare Inc. [sic], Case Number 09CV008356, Case Code 30301. The Complaint includes a demand for a jury trial and alleges that Merge unreasonably refused Mortimore and Noshay's request for indemnification; requests the court order that they are entitled to indemnification under Wisconsin Statute Section 180.0851(2); alleges breaches of certain employment agreements; and a breach of the covenant of good faith and fair dealing. Monetary damages being sought are unspecified. We have retained litigation counsel, notified our appropriate insurers and intend to vigorously defend this action.

In addition to the matters discussed above, we are, from time to time, parties to legal proceedings, lawsuits and other claims incident to our business activities. Such matters may include, among other things, assertions of contract breach or intellectual property infringement, claims for indemnity arising in the course of our business and claims by persons whose employment has been terminated. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. Consequently, we are unable to ascertain the ultimate aggregate amount of monetary liability, amounts which may be covered by insurance or recoverable from third parties, or the financial impact with respect to these matters as of the date of this report.

(10) Restructuring

On July 20, 2009, we completed a restructuring initiative to reduce our workforce by approximately 35 individuals. This action was taken concurrent with the acquisition of etrials based upon our assessment of ongoing personnel needs. As a result, we incurred $935 and $784 of severance and related costs in our Indirect and Direct segments, respectively, in the third quarter of 2009. These expenses are recorded in the trade name impairment, restructuring and other line of our statement of operations. The majority of these expenses will be paid out over the next several quarters.

In addition, we completed two other separate restructuring and reorganization initiatives in 2008, which had remaining obligations as of December 31, 2008.

The following table illustrates the activity related to these three initiatives in the nine months ended September 30, 2009:

	Employee Termination Costs	Contract Exit Costs	Total
First Quarter 2008 Initiative			
Balance at December 31, 2008	$ 31	$ 284	$ 315
Charges to expense	-	-	-
Payments	(7)	-	(7)
Foreign exchange	4	-	4
Balance at September 30, 2009	28	284	312
Second Quarter 2008 Initiative			
Balance at December 31, 2008	502	371	873
Charges to expense	-	-	-
Payments	(453)	(273)	(726)

Foreign exchange	3	15	18
Balance at September 30, 2009	52	113	165
Third Quarter 2009 Initiative			
Balance at December 31, 2008	-	-	-
Charges to expense	1,719	-	1,719
Payments	(633)	-	(633)
Foreign exchange	21	-	21
Balance at September 30, 2009	1,107	-	1,107
Total Balance at September 30, 2009	$ 1,187	$ 397	$ 1,584

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At September 30, 2009, $1,582 of the remaining balance was recorded in the restructuring accrual in current liabilities, with the remainder recorded in other long term liabilities.

(11) Income Taxes

We record income tax expense on an interim basis. The estimated annual effective income tax rate is adjusted quarterly and items discrete to a specific quarter are reflected in tax expense for that interim period. The estimated annual effective income tax rate reflects the effect of changes in a valuation allowance due to expected current year earnings or loss. A valuation allowance is established when necessary to reduce deferred tax assets to the amount more-likely-than-not to be realized. Further limitations may apply to deferred tax assets if ownership changes occur. There was no material change in unrecognized tax benefits in the nine month period ending September 30, 2009, and we do not anticipate a material change in total unrecognized tax benefits within the next 12 months.

(12) Earnings Per Share

Basic and diluted net earnings or loss per share is computed by dividing earnings or loss available to common shareholders by the weighted average number of shares of Common Stock outstanding. Diluted earnings per share includes the dilution that could occur based on outstanding restricted stock awards and the potential exercise of stock options, except for stock options with an exercise price of more than the average market price of our Common Stock, as such exercise would be anti-dilutive. The following table sets forth the computation of basic and diluted earnings per share for the periods indicated:

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Numerator:				
Net income (loss)	$ (936)	$ 428	$ 2,352	$ (25,601)
Denominator:				
Weighted average number of shares of Common Stock outstanding - basic	61,077,637	56,171,905	57,904,467	43,496,189
Effect of stock options	-	65,883	1,167,966	-
Effect of restricted stock	-	621,591	479,997	-
Denominator for net income (loss) per share - diluted	61,077,637	56,859,379	59,552,430	43,496,189
Net income (loss) per share - basic	$ (0.02)	$ 0.01	$ 0.04	$ (0.59)
Net income (loss) per share - diluted	$ (0.02)	$ 0.01	$ 0.04	$