

MERGE HEALTHCARE INC
Form 10-Q
August 09, 2011

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

FORM 10-Q

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

For the quarterly period ended June 30, 2011

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 001-33006

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.)

200 East Randolph Street, 24th Floor
Chicago, Illinois 60601-6436
(Address of principal executive offices, including zip code)

(Registrant's telephone number, including area code) (312) 565-6868

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company

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

The number of shares outstanding of the Registrant's common stock, par value \$0.01 per share, as of August 5, 2011: 89,646,785

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PART I – FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except for share data)

| ASSETS | June 30, 2011 | December 31, 2010 |
|---|------------------|----------------------|
| Current assets: | | |
| Cash and cash equivalents, including restricted cash of \$767 and \$1,647 at June 30, 2011 and December 31, 2010, respectively | \$45,234 | \$ 41,029 |
| Accounts receivable, net of allowance for doubtful accounts and sales returns of \$2,565 and \$1,322 at June 30, 2011 and December 31, 2010, respectively | 58,481 | 53,254 |
| Inventory | 3,095 | 3,486 |
| Prepaid expenses | 3,679 | 4,191 |
| Deferred income taxes | 2,545 | 2,545 |
| Other current assets | 11,853 | 9,336 |
| Total current assets | 124,887 | 113,841 |
| Property and equipment: | | |
| Computer equipment | 9,742 | 9,859 |
| Office equipment | 1,802 | 2,007 |
| Leasehold improvements | 1,201 | 1,055 |
| | 12,745 | 12,921 |
| Less accumulated depreciation | 7,737 | 7,149 |
| Net property and equipment | 5,008 | 5,772 |
| Purchased and developed software, net of accumulated amortization of \$6,963 and \$9,811 at June 30, 2011 and December 31, 2010, respectively | 24,016 | 26,619 |
| Other intangible assets, net of accumulated amortization of \$9,722 and \$8,419 at June 30, 2011 and December 31, 2010, respectively | 41,986 | 48,957 |
| Goodwill | 171,578 | 169,533 |
| Deferred income taxes | 14,566 | 17,006 |
| Other assets | 13,578 | 14,660 |
| Total assets | \$395,619 | \$ 396,388 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$16,629 | \$ 18,370 |
| Interest payable | 4,935 | 3,917 |
| Accrued wages | 6,426 | 4,304 |
| Restructuring accrual | 1,027 | 1,707 |
| Other accrued liabilities | 7,772 | 6,875 |
| Deferred revenue | 42,134 | 49,876 |
| Total current liabilities | 78,923 | 85,049 |
| Notes payable, net of unamortized discount | 249,065 | 195,077 |
| Deferred revenue | 5,104 | 3,809 |
| Income taxes payable | 5,707 | 5,683 |
| Other | 1,464 | 1,964 |

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| | | |
|--|------------|------------|
| Total liabilities | 340,263 | 291,582 |
| Shareholders' equity: | | |
| Series A Non-voting Preferred Stock, \$0.01 par value: 50,000 shares authorized; zero and 41,750 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively. Aggregate liquidation preference: zero and \$54,275 at June 30, 2011 and December 31, 2010, respectively. | - | 41,750 |
| Common stock, \$0.01 par value: 150,000,000 shares authorized: 84,367,509 shares and 83,258,123 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively | 844 | 833 |
| Common stock subscribed, 14,372 shares and 991,053 shares at June 30, 2011 and December 31, 2010, respectively | 71 | 3,323 |
| Additional paid-in capital | 525,675 | 527,228 |
| Accumulated deficit | (473,146) | (469,872) |
| Accumulated other comprehensive income | 1,912 | 1,544 |
| Total shareholders' equity | 55,356 | 104,806 |
| Total liabilities and shareholders' equity | \$395,619 | \$ 396,388 |

See accompanying notes to unaudited condensed consolidated financial statements.

IndexMERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except for share and per share data)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Net sales: | | | | |
| Software and other | \$17,639 | \$6,592 | \$36,310 | \$15,957 |
| Professional services | 10,515 | 5,631 | 18,915 | 9,377 |
| Maintenance and EDI | 27,438 | 16,780 | 53,039 | 23,639 |
| Total net sales | 55,592 | 29,003 | 108,264 | 48,973 |
| Cost of sales: | | | | |
| Software and other | 4,681 | 1,690 | 11,258 | 2,394 |
| Professional services | 5,016 | 4,028 | 10,079 | 7,025 |
| Maintenance and EDI | 6,687 | 5,809 | 14,651 | 7,306 |
| Depreciation, amortization and impairment | 2,347 | 4,487 | 4,846 | 5,705 |
| Total cost of sales | 18,731 | 16,014 | 40,834 | 22,430 |
| Gross margin | 36,861 | 12,989 | 67,430 | 26,543 |
| Operating costs and expenses: | | | | |
| Sales and marketing | 7,853 | 4,189 | 16,546 | 7,008 |
| Product research and development | 7,017 | 5,752 | 13,769 | 9,008 |
| General and administrative | 8,264 | 5,591 | 14,854 | 9,442 |
| Acquisition-related expenses | 375 | 2,421 | 479 | 8,359 |
| Restructuring and other expenses | - | 3,483 | (36) | 3,483 |
| Depreciation, amortization and impairment | 5,223 | 2,181 | 7,873 | 3,021 |
| Total operating costs and expenses | 28,732 | 23,617 | 53,485 | 40,321 |
| Operating income (loss) | 8,129 | (10,628) | 13,945 | (13,778) |
| Other income (expense): | | | | |
| Interest expense | (6,746) | (4,316) | (13,106) | (4,321) |
| Interest income | 167 | 8 | 173 | 23 |
| Other, net | (1,209) | 33 | (1,415) | 69 |
| Total other expense, net | (7,788) | (4,275) | (14,348) | (4,229) |
| Income (loss) before income taxes | 341 | (14,903) | (403) | (18,007) |
| Income tax expense | 2,026 | 58 | 2,871 | 106 |
| Net loss | (1,685) | (14,961) | (3,274) | (18,113) |
| Less: preferred stock dividends | 1,587 | 15,944 | 3,153 | 15,944 |
| Net loss available to common shareholders | \$(3,272) | \$(30,905) | \$(6,427) | \$(34,057) |
| Net loss per share - basic | \$(0.04) | \$(0.39) | \$(0.08) | \$(0.44) |
| Weighted average number of common shares outstanding | | | | |
| - basic | 84,345,025 | 80,092,926 | 84,277,343 | 77,461,669 |
| Net loss per share - diluted | \$(0.04) | \$(0.39) | \$(0.08) | \$(0.44) |
| Weighted average number of common shares outstanding | | | | |
| - diluted | 84,345,025 | 80,092,926 | 84,277,343 | 77,461,669 |

See accompanying notes to unaudited condensed consolidated financial statements.

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

| | Six Months Ended June 30, | |
|---|------------------------------|-------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net loss | \$(3,274) | \$(18,113) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation, amortization and impairment | 12,719 | 8,726 |
| Share-based compensation | 2,120 | 816 |
| Change in contingent consideration for acquisitions | 128 | 342 |
| Amortization of notes payable issuance costs & discount | 1,156 | 452 |
| Provision for doubtful accounts receivable and sales returns, net of recoveries | 782 | (277) |
| Deferred income taxes | 2,440 | - |
| Realized gain on sale of equity security | (405) | - |
| Changes in operating assets and liabilities, net of effects of acquisitions: | | |
| Accounts receivable | (6,432) | (1,954) |
| Inventory | 391 | (151) |
| Prepaid expenses | 479 | 1,012 |
| Accounts payable | (2,814) | 645 |
| Accrued wages | 2,035 | (329) |
| Restructuring accrual | (892) | 2,100 |
| Deferred revenue | (6,784) | 3,987 |
| Accrued interest and other liabilities | 217 | 2,506 |
| Other | (439) | 2,105 |
| Net cash provided by operating activities | 1,427 | 1,867 |
| Cash flows from investing activities: | | |
| Cash paid for acquisitions, net of cash acquired | (600) | (210,226) |
| Purchases of property, equipment, and leasehold improvements | (1,277) | (745) |
| Change in restricted cash | 880 | 42 |
| Distribution from investment in equity security | 405 | 76 |
| Net cash used in investing activities | (592) | (210,853) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of term notes | 53,560 | 194,532 |
| Proceeds from issuance of stock | - | 41,750 |
| Note and stock issuance costs paid | (1,528) | (8,946) |
| Proceeds from exercise of stock options and employee stock purchase plan | 206 | 57 |
| Principal payments on capital leases | (41) | (48) |
| Redemption and retirement of preferred stock | (40,750) | - |
| Preferred stock dividends | (7,152) | - |
| Net cash provided by financing activities | 4,295 | 227,345 |
| Effect of exchange rates on cash and cash equivalents | (45) | - |
| Net increase in cash and cash equivalents | 5,085 | 18,359 |
| Cash and cash equivalents (net of restricted cash), beginning of period (1) | 39,382 | 19,062 |
| Cash and cash equivalents (net of restricted cash), end of period (2) | \$44,467 | \$37,421 |

Supplemental Disclosures of Cash Flow Information:

| | | |
|--|----------|--------|
| Cash paid for interest, net of receipts | \$10,919 | \$8 |
| Cash paid for income taxes, net of refunds | 291 | (225) |

(1) Net of restricted cash of \$1,647 and \$559 at December 31, 2010 and 2009, respectively.

(2) Net of restricted cash of \$767 and \$517 at June 30, 2011 and 2010, respectively.

See accompanying notes to unaudited condensed consolidated financial statements.

IndexMERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(Unaudited)

(in thousands, except for share and per share data)

| | Preferred Stock | | Common Stock | | | | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|------------------|------------------|----------------------|----------------------|------------------|------------------|----------------------------------|------------------------|---|----------------------------------|
| | Shares Issued | Issued Amount | Shares Subscribed | Subscribed Amount | Shares Issued | Issued Amount | | | | |
| Balance at December 31, 2010 | 41,750 | \$41,750 | 991,053 | \$3,323 | 83,258,123 | \$833 | \$527,228 | \$(469,872) | \$1,544 | \$104,806 |
| Stock issued under ESPP | - | - | (1,980) | 13 | 29,235 | - | 118 | - | - | 131 |
| Exercise of stock options | - | - | - | - | 25,000 | - | 75 | - | - | 75 |
| Share-based compensation expense | - | - | - | - | - | - | 2,120 | - | - | 2,120 |
| Shares issued for acquisitions | - | - | (974,701) | (3,265) | 1,055,151 | 11 | 3,462 | - | - | 208 |
| Preferred stock dividends paid | - | - | - | - | - | - | (7,328) | - | - | (7,328) |
| Redemption and cancellation of Series A Preferred Stock | (41,750) | (41,750) | - | - | - | - | - | - | - | (41,750) |
| Net loss | - | - | - | - | - | - | - | (3,274) | - | (3,274) |
| Other comprehensive income | - | - | - | - | - | - | - | - | 368 | 368 |
| Balance at June 30, 2011 | - | \$- | 14,372 | \$71 | 84,367,509 | \$844 | \$525,675 | \$(473,146) | \$1,912 | \$55,356 |

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 | | Six Months Ended | |
|---|--------------------|-------------|------------------|-------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Net loss | \$(1,685) | \$(14,961) | \$(3,274) | \$(18,113) |
| Translation adjustment | 195 | - | 175 | - |
| Unrealized gain (loss) on marketable security, net of taxes | (55) | (29) | 193 | (42) |
| Comprehensive loss | \$(1,545) | \$(14,990) | \$(2,906) | \$(18,155) |

See accompanying notes to unaudited condensed consolidated financial statements.

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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, 2010 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 six month periods ended June 30, 2011 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.

(2) Other Current Assets and Other Accrued Liabilities

Other current assets consist primarily of revenue recognized that has not yet been billed to a customer, taxes receivable and other non-trade receivables, all of which are due within the next twelve months. The balances are comprised of the following as of June 30, 2011 and December 31, 2010:

| | Balance at June 30, 2011 | Balance at December 31, 2010 |
|--|--------------------------------|------------------------------------|
| Revenue recognized in excess of billings | \$ 10,851 | \$ 8,337 |
| Taxes receivable | 16 | 848 |
| Other non-trade receivables | 986 | 151 |
| | \$ 11,853 | \$ 9,336 |

Other accrued liabilities consist primarily of leases payable, deferred tax liability, accrued taxes and other non-trade payables, all of which are due within the next twelve months. The balances are comprised of the following as of June 30, 2011 and December 31, 2010:

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| | Balance at June 30, 2011 | Balance at December 31, 2010 |
|---------------------------|--------------------------------|------------------------------------|
| Leases payable | \$ 501 | \$ 679 |
| Deferred tax liability | 732 | 732 |
| Accrued taxes | 1,477 | 1,296 |
| Amounts due investors | 1,339 | 163 |
| Other current liabilities | 3,723 | 4,005 |
| | \$ 7,772 | \$ 6,875 |

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

(3) Goodwill and Other Intangible Assets

Goodwill

Changes in the carrying amount of goodwill for the six months ended June 30, 2011, are as follows:

| | Total |
|---|------------|
| Balance at December 31, 2010 | \$ 169,533 |
| Changes due to insignificant acquisitions | 1,915 |
| Change due to effect of foreign currency | 130 |
| Balance at June 30, 2011 | \$ 171,578 |

Other Intangible Assets

Our intangible assets subject to amortization are summarized as of June 30, 2011 as follows:

| | Weighted Average Remaining Amortization Period (Years) | Gross Carrying Amount | Accumulated Amortization |
|------------------------|---|-----------------------------|-----------------------------|
| Purchased software | 6.0 | \$ 29,155 | \$ (5,728) |
| Capitalized software | 3.1 | 1,824 | (1,235) |
| Customer relationships | 8.3 | 38,951 | (4,833) |
| Backlog | 3.5 | 8,100 | (4,108) |
| Trade names | 9.0 | 1,467 | (261) |
| Non-competes | 5.8 | 3,190 | (520) |
| Total | | \$ 82,687 | \$ (16,685) |

In the six months ended June 30, 2011, we increased the gross carrying amount of purchased software, customer relationships, trade names and non-competes by \$99, \$741, \$120 and \$130, respectively, related to an insignificant acquisition in 2011. In the second quarter of 2011, we wrote off \$5,635 and \$3,476, respectively, of the gross carrying amount and accumulated amortization of certain purchased software assets and customer relationship assets which were fully amortized.

Upon completion of a product rebranding initiative in the second quarter of 2011, we recorded a \$2,805 charge due to the impairment of our trade names associated with certain products. We also wrote off fully amortized gross carrying amounts and accumulated amortization of \$3,167 in trade name assets. In the second quarter of 2010, as a result of decisions related to overlapping products, we recorded \$2,271 of impairment expense to fully write off certain purchased software assets related to products from which we expect no future cash flows.

Estimated aggregate amortization expense for our intangible assets, which become fully amortized in 2022, is as follows:

| | | |
|---|------------|--------|
| For the remaining 6 months of the year ended: | 2011 \$ | 6,769 |
| For the year ended December 31: | 2012 | 12,243 |
| | 2013 | 11,300 |
| | 2014 | 10,200 |
| | 2015 | 7,968 |
| | Thereafter | 17,522 |
| | Total \$ | 66,002 |

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

Amortization expense for the three and six months ended June 30, 2011 and 2010 is set forth in the following table:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|----------|------------------------------|----------|
| | 2011 | 2010 | 2011 | 2010 |
| Amortization and impairment included in cost of sales: | | | | |
| Purchased software | \$ 1,269 | \$ 3,554 | \$ 2,653 | \$ 4,416 |
| Capitalized software | 50 | 285 | 102 | 414 |
| Backlog | 936 | 273 | 1,873 | 273 |
| Total | 2,255 | 4,112 | 4,628 | 5,103 |
| Amortization and impairment included in operating expenses: | | | | |
| Customer relationships | 1,351 | 918 | 2,772 | 1,313 |
| Trade names | 2,955 | 69 | 3,077 | 88 |
| Non-competes | 127 | 74 | 252 | 74 |
| Total | 4,433 | 1,061 | 6,101 | 1,475 |
| Total amortization and impairment | \$ 6,688 | \$ 5,173 | \$ 10,729 | \$ 6,578 |

(4) Fair Value Measurement

Our financial instruments include cash and cash equivalents, accounts receivable, marketable and non-marketable securities, accounts payable, notes payable, and certain accrued liabilities. The carrying amounts of our cash and cash equivalents (which are comprised primarily of deposit and overnight sweep accounts), accounts receivable, accounts payable, and certain accrued liabilities approximate fair value due to the short maturity of these instruments. The carrying amount of our marketable equity security is based on the quoted price of the security in an active market. The estimated fair values of the non-marketable equity securities have been determined from information obtained from independent valuations and management estimates. The carrying value of our notes payable approximates fair value due to the interest rates and terms approximating those available to the company for similar obligations.

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.

Non-Current Investments

At June 30, 2011, we held certain securities in a publicly traded entity and a private company which are classified within other assets on our condensed consolidated balance sheet. The investment in the publicly traded equity security, over which we do not exert significant influence, is classified as “available-for-sale” and reported at fair value on a recurring basis. Unrealized gains and losses are reported within the accumulated other comprehensive income component of shareholders’ equity. The investment in equity securities of a private company, over which we do not exert significant influence, is classified as a Level 3 investment and is reported at cost or fair value, if an other-than-temporary loss has been determined. Any loss due to impairment in value is recorded when such loss occurs. We performed the evaluation of our Level 3 investment as of June 30, 2011, and concluded that there was no significant change in its fair value.

In the three and six months ended June 30, 2011, we received proceeds of \$405 from the sale of an investment in equity securities of a private company, which had a carrying value of zero, and recorded a \$405 gain in other income (expense) on our statements of operations.

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

The following table sets forth the change in the fair value of our Level 1 publicly traded equity security:

| Rollforward of Level 1 Investment | Six Months Ended | |
|-----------------------------------|------------------|--------|
| | June 30, | |
| | 2011 | 2010 |
| Balance at January 1 | \$ 55 | \$ 110 |
| Unrealized gain (loss) | 221 | (42) |
| Balance at June 30 | \$ 276 | \$ 68 |

Unrealized gains or losses on our Level 1 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:

| | December 31, | |
|--|---------------|----------|
| | June 30, 2011 | 2010 |
| Cumulative translation adjustment | \$ 2,111 | \$ 1,936 |
| Unrealized loss on available-for-sale security, net of taxes | (199) | (392) |
| Total accumulated other comprehensive income | \$ 1,912 | \$ 1,544 |

(5) Restructuring

The following table sets forth the activity in the six months ended June 30, 2011, related to restructuring activities taken in prior years:

| | Employee Termination | | Contract Exit | | Relocation | Total |
|------------------------------|----------------------|----------|---------------|----------|------------|-------|
| | Costs | Costs | Costs | Costs | | |
| Balance at December 31, 2010 | \$ 449 | \$ 1,698 | \$ 42 | \$ 2,189 | | |
| Adjustments to expense | (11) | - | (25) | (36) | | |
| Payments | (41) | (803) | (15) | (859) | | |
| Foreign exchange | 3 | - | - | 3 | | |
| Balance at June 30, 2011 | \$ 400 | \$ 895 | \$ 2 | \$ 1,297 | | |

As of June 30, 2011, \$1,027 of the remaining balance was recorded in the restructuring accrual in current liabilities, with the remainder recorded in other long term liabilities.

(6) Debt

In April 2010, we issued \$200,000 of Senior Secured Notes (Notes) at 97.266% of the principal amount, which bear interest at 11.75% of principal (payable on May 1st and November 1st of each year) and will mature on May 1, 2015. The Notes were offered in a private placement pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. In connection with the Notes, we incurred issuance costs of \$9,015 (which are recorded in

other assets on the condensed consolidated balance sheet). These issuance costs are recorded as a long-term asset and amortized over the life of the Notes using the effective interest method.

In June 2011, we issued an additional \$52,000 in Notes at 103.0% of the principal amount with terms identical to the existing Notes. The proceeds of these additional Notes were used to redeem and retire our Series A Preferred Stock and to pay associated dividends (as further discussed in Note 7). These additional Notes were offered in a private placement pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. Prior to issuance, we received consents from the majority of holders of the existing Notes to amend the Indenture to allow us to incur the additional indebtedness. As consideration for the consents, we paid \$1,528 in consent fees from the proceeds of the Notes. These fees are recorded as an issuance cost in long-term assets and will be amortized over the remaining life of the Notes using the effective interest method. We also incurred \$1,442 in costs related to the issuance of the additional Notes that did not qualify for capitalization. These costs are recorded in "other expense, net" of our statements of operations for the three and six months ended June 30, 2011.

In the three and six months ended June 30, 2011, we recorded \$6,650 and \$13,093, respectively, of interest expense related to the Notes, including \$376 and \$729, respectively, in amortization of debt issuance costs and \$213 and \$427, respectively, in amortization of debt discount. In the three and six months ended June 30, 2010, we recorded \$4,368 and \$4,368, respectively, of interest expense related to the Notes, including \$276 and \$276, respectively, in amortization of debt issuance costs and \$176 and \$176, respectively, in amortization of debt discount. As of June 30, 2011 and 2010, the notes payable balances on our balance sheet included \$2,935 and \$4,923, respectively, of unamortized net discount.

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

(7) Shareholders' Equity

In the three and six months ended June 30, 2011, we recorded dividends of \$1,587 and \$3,153, respectively, related to our preferred stock. These dividends are reflected as a reduction of net income available to common shareholders in our condensed statement of operations.

In June 2011, we redeemed and retired all 41,750 outstanding shares of our Series A Preferred Stock at the face value of \$41,750 and paid cumulative dividends of \$7,328. Prior to the redemption, shareholders of our Series A Preferred Stock waived the two-year liquidation preference.

In the six months ended June 30, 2011, we issued 974,701 shares of our common stock as partial consideration for an insignificant acquisition which was completed in the fourth quarter of 2010. These shares had been recorded as common stock subscribed as of December 31, 2010. We also issued 80,450 shares of our common stock as partial consideration for an insignificant acquisition which was completed in the second quarter of 2011 and will issue up to an additional 120,674 shares of our common stock subject to achievement of certain contingent consideration provisions in the acquisition agreement.

(8) Share-Based Compensation

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-------|------------------------------|-------|
| | 2011 | 2010 | 2011 | 2010 |
| Share-based compensation expense included in the statement of operations: | | | | |
| Professional services cost of sales | \$9 | \$22 | \$19 | \$28 |
| Maintenance and EDI cost of sales | 83 | 2 | 111 | 2 |
| Sales and marketing | 248 | 68 | 835 | 151 |
| Product research and development | 17 | 93 | 9 | 155 |
| General and administrative | 701 | 277 | 1,146 | 480 |
| Total | \$1,058 | \$462 | \$2,120 | \$816 |

Stock option activity in the six months ended June 30, 2011 is set forth in the following table:

| | Number of Options |
|--|----------------------|
| Options outstanding, December 31, 2010 | 7,959,110 |
| Options granted | 1,465,000 |
| Options exercised | (25,000) |
| Options forfeited and expired | (148,717) |
| Options outstanding, June 30, 2011 | 9,250,393 |

| | |
|------------------------------------|-----------|
| Options exercisable, June 30, 2011 | 3,713,205 |
|------------------------------------|-----------|

As of June 30, 2011, there was approximately \$9,447 of unrecognized compensation cost related to stock options that may be recognized in future periods.

On June 2, 2011, our shareholders approved an amendment to our 2005 Equity Incentive Plan to increase the number of shares of common stock authorized for issuance thereunder by 3,000,000 to 16,500,000 shares of our common stock.

(9) Commitments and Contingencies

On June 1, 2009, Merge Healthcare was sued in the Milwaukee County Circuit Court, State of Wisconsin, by William C. Mortimore and David M. Noshay with respect to the separation of Mortimore's and Noshay's employment and our subsequent refusal to indemnify them with respect to litigation related to their services as officers of Merge. The plaintiffs allege that we breached their employment agreements, unreasonably refused their requests for indemnification and breached other covenants of good faith and fair dealing. The plaintiffs seek indemnification and unspecified monetary damages. Discovery in this case is on-going. On April 6, 2011, the Milwaukee County Circuit Court rendered a decision in which it concluded that Merge and Mortimore had entered into an oral employment contract on or about June 15, 2006, but the Court did not make any decision as to damages, which would be addressed in a later phase of the litigation. On May 9, 2011, Merge appealed the Circuit Court's decision. The appeal is ongoing and the Circuit Court litigation has been stayed pending appeal. We have retained litigation counsel, intend to continue to defend this action vigorously and have filed a counterclaim for fraud, among other claims, against both Mortimore and Noshay. We will also continue to pursue the appeal.

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Merge Healthcare Incorporated and Subsidiaries

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(Unaudited and in thousands, except for share and per share data)

In January 2010, a purported stockholder class action complaint was filed in the Superior Court of Suffolk County, Massachusetts in connection with AMICAS Inc.'s (AMICAS) proposed acquisition by Thoma Bravo, LLC (the "Thoma Bravo Merger"). A second similar action was filed in the same Court in February 2010 and consolidated with the first action. In March 2010, because AMICAS had terminated the Thoma Bravo Merger and agreed to be acquired by us, the Court dismissed the plaintiffs' claims as moot. Subsequently, counsel for the plaintiffs filed an application for approximately \$5,000 of attorneys' fees for its work on this case, which fee petition AMICAS opposed. We retained litigation counsel to defend against the fee petition. On December 4, 2010, the Court awarded plaintiffs approximately \$3,200 in attorneys' fees and costs. AMICAS has filed a notice of appeal from this judgment, and the plaintiffs have cross-appealed. We previously tendered the defense in this matter to our appropriate insurers, who have provided coverage against the claims asserted against AMICAS. After receipt of the Court's attorneys' fee award decision, the applicable insurer denied policy coverage for approximately \$2,500 of the fee award. We do not believe that the insurer's denial has merit and have retained counsel to contest it. We will vigorously assert all of our rights under our applicable insurance policies, which we believe cover the claims and expenses incurred by AMICAS or us in connection with the fee award. On June 6, 2011, the insurer filed an action against AMICAS, Inc. and Merge in Federal Court in the Northern District of Illinois seeking a declaration that it is not responsible for the \$2,500 portion of the judgment rendered in the December 4, 2010 judgment from the Superior Court of Suffolk County, Massachusetts. Merge intends to file a counterclaim seeking a declaration that the insurer must pay the full amount of the Superior Court's fee award, plus additional damages. Merge intends to seek a dismissal of the insurer's action. However, an adverse outcome could negatively impact our financial condition.

On February 1, 2010, Merge filed a complaint against its former CEO, Richard Linden, and its former CFO, Scott Veech, in the U.S. District for the Eastern District of Wisconsin, seeking a declaration that we do not have to indemnify either Linden or Veech for liabilities they incurred in connection with SEC investigation and enforcement actions and various securities fraud and shareholder derivative litigation. Merge also seeks to recover from both defendants all costs incurred by Merge associated with defending Linden and Veech in those prior actions. On October 15, 2010, the Court concluded that it did not have subject matter jurisdiction over Merge's claims and dismissed the claims in their entirety. The Court rendered no opinion on the merits of Merge's claims. Merge is evaluating its further options with respect to the Scott Veech matter in Wisconsin state court. On February 8, 2011, Merge filed a complaint in the U.S. District Court for the Eastern District of Wisconsin captioned Merge Healthcare Incorporated v. Richard Linden, Case no. 11-CV-001541. On May 4, 2011, Merge and Linden entered into a confidential settlement agreement resolving all claims against Mr. Linden and through which Linden agreed to issue a statement of regret and apology to Merge's Board of Directors and reimburse Merge for a portion of the Company's legal fees to defend Linden in prior legal actions. Merge believes that it has numerous meritorious claims against Mr. Veech and will continue to pursue these claims, which have not been affected by the settlement with Mr. Linden.

In August, 2010, Merge Healthcare was sued in the Northern District of Texas by the Court-appointed receiver for Stanford International Bank, Ltd. The receiver alleges that Merge was a recipient of a fraudulent conveyance as a result of a Ponzi scheme orchestrated by Robert Stanford and Stanford International Bank, Ltd. (SIBL). Merge is not alleged to have participated in the Ponzi scheme. The receiver's claims arise from the failed acquisition of Emageon, Inc. (Emageon) by Health Systems Solutions, Inc. (HSS), an affiliate of SIBL, in February 2009, which resulted in the payment of a \$9,000 break-up fee by HSS, which payment is alleged to have been financed by SIBL. Merge subsequently acquired Emageon as part of our AMICAS acquisition. The complaint seeks to recover the \$9,000 payment to Emageon, plus interest, costs, and attorneys' fees. We have retained litigation counsel and intend to

vigorously defend this action. We have filed a motion to dismiss the complaint. That motion has been fully briefed, and we are awaiting a decision from the Court. However, an adverse outcome could negatively impact our operating results and financial condition.

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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. We are unable to estimate 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.

Guarantees

As a result of the acquisition of AMICAS, we assumed a guarantee to a lender on behalf of a customer. At June 30, 2011, the balance outstanding on the loan was approximately \$805. As the customer makes loan payments to the lender, the guarantee is reduced.

(10) Transactions with Related Party

Effective January 1, 2009, we entered into a consulting agreement with Merrick RIS, LLC (Merrick), an affiliate of Merrick Ventures, LLC (Merrick Ventures). We amended the agreement effective January 1, 2010 to extend the term through December 31, 2011, and modify the payment terms from a flat fee arrangement per quarter to a per transaction or success based arrangement. 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 all of the shares owned by Merrick. As of June 30, 2011, Merrick and its affiliates owned approximately 37.6% of our common stock.

In the three and six month periods ended June 30, 2011, we incurred \$450 and \$544, respectively, in expenses and paid \$250 and \$554, respectively, to Merrick for such services. In the three and six month periods ended June 30, 2010, we incurred \$1,055 and \$1,308, respectively, in expenses and paid \$1,265 and \$1,265, respectively, to Merrick for such services. As of June 30, 2011 and 2010, we had \$294 and \$57, respectively, recorded in accounts payable covering all obligations under this agreement.

On April 1, 2010, we entered into a Securities Purchase Agreement with Merrick, under which Merrick subscribed to purchase 10,000 shares of Series A Non-Voting Preferred Stock, par value \$0.01 per share (Series A Preferred Stock) and 1,800,000 shares of common stock for an aggregate purchase price of \$10,000, under the same terms and conditions as other investors. On June 20, 2011, we redeemed all outstanding Series A Preferred Stock and paid Merrick the \$10,000 face value as well as \$1,755 in cumulative dividends, under the same terms and conditions as other investors.

On April 28, 2010, Merrick purchased, at the same purchase price per Note as the other investors in the offering, \$5,000 of the \$200,000 aggregate principal amount of Notes that we issued to complete our acquisition of AMICAS. On June 20, 2011, Merrick purchased, at the same purchase price per Note as the other investors in the offering, \$5,000 of the \$52,000 aggregate principal amount of additional Notes.

(11) Income Taxes

We are subject to tax in multiple jurisdictions and record income tax expense on an interim basis using an estimated annual effective tax rate. The estimated annual effective tax rate is modified to exclude the effect of losses for those jurisdictions where the tax benefit cannot be recognized and a separate estimated annual tax rate is required. Items discrete to a specific quarter are reflected in tax expense for that interim period. 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 three and six month periods ended June 30, 2011. Within the next twelve months we estimate that unrecognized tax benefits will decrease by approximately \$4,600 due to statute of limitations expirations.

(12) Earnings Per Share Available to Common Shareholders

Basic and diluted net earnings or loss per share are computed by dividing earnings or loss available to common shareholders by the weighted average number of shares of common stock outstanding. Earnings or loss available to common shareholders is computed as net income or loss less the 15% cumulative annual compounding dividend earned by preferred shareholders, during the periods such stock was outstanding, in the respective periods. The computation of earnings or loss available to common shareholders is presented in our condensed consolidated statements of operations. 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.

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In the three months ended June 30, 2011 and 2010, options to purchase 541,161 and 2,014,829 shares of our common stock, respectively, had exercise prices greater than the average market price of our common stock, and, therefore, are not considered in the calculations of diluted net loss per share. In the six months ended June 30, 2011 and 2010, options to purchase 1,065,393 and 2,014,829 shares of our common stock, respectively, had exercise prices greater than the average market price of our common stock, and, therefore, are not considered in the calculations of diluted net loss per share.

As a result of the losses in the three months ended June 30, 2011 and 2010, incremental shares from the assumed conversion of employee stock options and restricted stock awards totaling 8,709,232 and 4,550,000 shares, respectively, have been excluded from the calculation of diluted loss per share as their inclusion would have been anti-dilutive. As a result of the losses in the six months ended June 30, 2011 and 2010, incremental shares from the assumed conversion of employee stock options and restricted stock awards totaling 8,185,000 and 4,550,000 shares, respectively, have been excluded from the calculation of diluted loss per share as their inclusion would have been anti-dilutive.

(13) Guarantor Subsidiaries

The obligations under the Notes are fully and unconditionally guaranteed, jointly and severally, by all of our current and future 100% owned domestic restricted subsidiaries (Guarantors). No other subsidiaries guarantee the Notes. The Notes and guarantees are secured by a first-priority lien on certain collateral which comprises substantially all of the Parent and Guarantors' tangible and intangible assets, subject to certain exceptions. The following tables present the balance sheets, statements of operations and statements of cash flows of the Parent, Guarantor and Non-Guarantor entities along with the eliminations necessary to arrive at the information on a consolidated basis.

General corporate expenses, including public company costs, certain amortization, corporate administration costs, acquisition-related expenses and net interest expense are included in the results of the Parent.

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

CONDENSED CONSOLIDATING BALANCE SHEET

| | June 30, 2011 | | | | |
|---|---------------|------------|----------------|---------------|--------------|
| | Parent | Guarantors | Non-Guarantors | Eliminations | Consolidated |
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents (including restricted cash) | \$ 11,206 | \$ 29,577 | \$ 4,451 | \$ - | \$ 45,234 |
| Accounts receivable, net | - | 49,846 | 8,635 | - | 58,481 |
| Intercompany receivables | 3,799 | 16,105 | 689 | (20,593) | - |
| Other current assets | 989 | 15,864 | 4,319 | - | 21,172 |
| Total current assets | 15,994 | 111,392 | 18,094 | (20,593) | 124,887 |
| Net property and equipment | 132 | 4,321 | 555 | - | 5,008 |
| Purchased and developed software, net | - | 23,281 | 735 | - | 24,016 |
| Other intangible assets, net | - | 41,166 | 820 | - | 41,986 |
| Goodwill | - | 170,169 | 1,409 | - | 171,578 |
| Investment in and advances to subsidiaries | 292,417 | (64) | - | (292,353) | - |
| Other assets | 13,775 | 6,654 | 10,594 | (2,879) | 28,144 |
| Total assets | \$ 322,318 | \$ 356,919 | \$ 32,207 | \$ (315,825) | \$ 395,619 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | \$ 2,309 | \$ 12,630 | \$ 1,690 | \$ - | \$ 16,629 |
| Deferred revenue | - | 39,763 | 2,371 | - | 42,134 |
| Intercompany payables | - | 5,501 | 23,742 | (29,243) | - |
| Other accrued liabilities | 7,002 | 11,686 | 1,472 | - | 20,160 |
| Total current liabilities | 9,311 | 69,580 | 29,275 | (29,243) | 78,923 |
| Notes payable | 249,065 | - | - | - | 249,065 |
| Other long-term liabilities | 8,586 | 5,706 | 862 | (2,879) | 12,275 |
| Total liabilities | 266,962 | 75,286 | 30,137 | (32,122) | 340,263 |
| Total shareholders' equity | 55,356 | 281,633 | 2,070 | (283,703) | 55,356 |
| Total liabilities and shareholders' equity | \$ 322,318 | \$ 356,919 | \$ 32,207 | \$ (315,825) | \$ 395,619 |

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

CONDENSED CONSOLIDATING BALANCE SHEET

| | December 31, 2010 | | | | |
|---|-------------------|------------|----------------|---------------|--------------|
| | Parent | Guarantors | Non-Guarantors | Eliminations | Consolidated |
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents (including restricted cash) | \$870 | \$35,877 | \$ 4,282 | \$ - | \$ 41,029 |
| Accounts receivable, net | - | 48,201 | 5,053 | - | 53,254 |
| Intercompany receivables | 14,170 | 14,168 | 961 | (29,299) | - |
| Other current assets | 791 | 14,844 | 3,923 | - | 19,558 |
| Total current assets | 15,831 | 113,090 | 14,219 | (29,299) | 113,841 |
| Net property and equipment | 156 | 4,949 | 667 | - | 5,772 |
| Purchased and developed software, net | 601 | 25,210 | 808 | - | 26,619 |
| Other intangible assets, net | 395 | 48,053 | 509 | - | 48,957 |
| Goodwill | - | 167,957 | 1,576 | - | 169,533 |
| Investment in and advances to subsidiaries | 284,893 | 1,830 | - | (286,723) | - |
| Other assets | 13,615 | 8,829 | 12,101 | (2,879) | 31,666 |
| Total assets | \$315,491 | \$369,918 | \$ 29,880 | \$ (318,901) | \$ 396,388 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | \$2,054 | \$14,155 | \$ 2,161 | \$ - | \$ 18,370 |
| Deferred revenue | - | 48,216 | 1,660 | - | 49,876 |
| Intercompany payables | - | 13,767 | 25,580 | (39,347) | - |
| Other accrued liabilities | 4,965 | 10,902 | 936 | - | 16,803 |
| Total current liabilities | 7,019 | 87,040 | 30,337 | (39,347) | 85,049 |
| Notes payable | 195,077 | - | - | - | 195,077 |
| Other long-term liabilities | 8,589 | 4,885 | 861 | (2,879) | 11,456 |
| Total liabilities | 210,685 | 91,925 | 31,198 | (42,226) | 291,582 |
| Total shareholders' equity | 104,806 | 277,993 | (1,318) | (276,675) | 104,806 |
| Total liabilities and shareholders' equity | \$315,491 | \$369,918 | \$ 29,880 | \$ (318,901) | \$ 396,388 |

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

| | Three Months Ended June 30, 2011 | | | | |
|--|----------------------------------|-----------|---------------|--------------|--------------|
| | Parent | Guarantor | Non-Guarantor | Eliminations | Consolidated |
| Net sales | \$- | \$46,369 | \$ 9,223 | \$ - | \$ 55,592 |
| Cost of sales | - | 17,417 | 1,314 | - | 18,731 |
| Gross margin | - | 28,952 | 7,909 | - | 36,861 |
| Selling, research and development, general and administrative expenses | 587 | 18,364 | 4,183 | - | 23,134 |
| Acquisition-related expenses | 375 | - | - | - | 375 |

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| | | | | | |
|---|------------|---------|----------|-------------|------------|
| Restructuring and other expenses | - | - | - | - | - |
| Depreciation, amortization and impairment | 104 | 5,021 | 98 | - | 5,223 |
| Total operating costs and expenses | 1,066 | 23,385 | 4,281 | - | 28,732 |
| Operating income (loss) | (1,066) | 5,567 | 3,628 | - | 8,129 |
| Equity in net income of subsidiaries | 8,091 | (475) | - | (7,616) | - |
| Other, net | (8,058) | (42) | 312 | - | (7,788) |
| Other income (expense) | 33 | (517) | 312 | (7,616) | (7,788) |
| Income (loss) before income taxes | (1,033) | 5,050 | 3,940 | (7,616) | 341 |
| Income tax expense | 652 | 264 | 1,110 | - | 2,026 |
| Net income (loss) | \$(1,685) | \$4,786 | \$ 2,830 | \$ (7,616) | \$(1,685) |

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

| | Three Months Ended June 30, 2010 | | | | |
|--|----------------------------------|-------------|---------------|--------------|--------------|
| | Parent | Guarantor | Non-Guarantor | Eliminations | Consolidated |
| Net sales | \$ - | \$ 25,549 | \$ 3,454 | \$ - | \$ 29,003 |
| Cost of sales | - | 14,559 | 1,455 | - | 16,014 |
| Gross margin | - | 10,990 | 1,999 | - | 12,989 |
| Selling, research and development, general and administrative expenses | 877 | 12,846 | 1,809 | - | 15,532 |
| Acquisition-related expenses | 2,391 | 30 | - | - | 2,421 |
| Restructuring and other expenses | 463 | 2,743 | 277 | - | 3,483 |
| Depreciation, amortization and impairment | 303 | 1,799 | 79 | - | 2,181 |
| Total operating costs and expenses | 4,034 | 17,418 | 2,165 | - | 23,617 |
| Operating income (loss) | (4,034) | (6,428) | (166) | - | (10,628) |
| Equity in net income of subsidiaries | (6,602) | (34) | - | 6,636 | - |
| Other, net | (4,218) | (29) | (28) | - | (4,275) |
| Other income (expense) | (10,820) | (63) | (28) | 6,636 | (4,275) |
| Income (loss) before income taxes | (14,854) | (6,491) | (194) | 6,636 | (14,903) |
| Income tax expense (benefit) | 107 | (49) | - | - | 58 |
| Net income (loss) | \$ (14,961) | \$ (6,442) | \$ (194) | \$ 6,636 | \$ (14,961) |

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

| | Six Months Ended June 30, 2011 | | | | |
|--|--------------------------------|-----------|---------------|--------------|--------------|
| | Parent | Guarantor | Non-Guarantor | Eliminations | Consolidated |
| Net sales | \$- | \$93,794 | \$ 14,470 | \$ - | \$ 108,264 |
| Cost of sales | - | 38,177 | 2,657 | - | 40,834 |
| Gross margin | - | 55,617 | 11,813 | - | 67,430 |
| Selling, research and development, general and administrative expenses | 2,404 | 35,661 | 7,104 | - | 45,169 |
| Acquisition-related expenses | 479 | - | - | - | 479 |
| Restructuring and other expenses | - | (36) | - | - | (36) |
| Depreciation, amortization and impairment | 260 | 7,400 | 213 | - | 7,873 |
| Total operating costs and expenses | 3,143 | 43,025 | 7,317 | - | 53,485 |
| Operating income (loss) | (3,143) | 12,592 | 4,496 | - | 13,945 |
| Equity in net income of subsidiaries | 15,074 | (1,287) | - | (13,787) | - |
| Other, net | (14,463) | (160) | 275 | - | (14,348) |

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| | | | | | |
|-----------------------------------|------------|----------|----------|-------------|------------|
| Other income (expense) | 611 | (1,447) | 275 | (13,787) | (14,348) |
| Income (loss) before income taxes | (2,532) | 11,145 | 4,771 | (13,787) | (403) |
| Income tax expense | 742 | 441 | 1,688 | - | 2,871 |
| Net income (loss) | \$(3,274) | \$10,704 | \$ 3,083 | \$(13,787) | \$(3,274) |

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

Six Months Ended June 30, 2010

| | Parent | Guarantor | Non-Guarantor | Eliminations | Consolidated |
|--|-------------|------------|---------------|--------------|--------------|
| Net sales | \$- | \$39,534 | \$ 9,439 | \$ - | \$ 48,973 |
| Cost of sales | - | 19,824 | 2,606 | - | 22,430 |
| Gross margin | - | 19,710 | 6,833 | - | 26,543 |
| Selling, research and development, general and administrative expenses | 1,068 | 20,438 | 3,952 | - | 25,458 |
| Acquisition-related expenses | 8,329 | 30 | - | - | 8,359 |
| Restructuring and other expenses | 463 | 2,743 | 277 | - | 3,483 |
| Depreciation, amortization and impairment | 520 | 2,339 | 162 | - | 3,021 |
| Total operating costs and expenses | 10,380 | 25,550 | 4,391 | - | 40,321 |
| Operating income (loss) | (10,380) | (5,840) | 2,442 | - | (13,778) |
| Equity in net income of subsidiaries | (3,491) | (93) | - | 3,584 | - |
| Other, net | (4,121) | (33) | (75) | - | (4,229) |
| Other income (expense) | (7,612) | (126) | (75) | 3,584 | (4,229) |
| Income (loss) before income taxes | (17,992) | (5,966) | 2,367 | 3,584 | (18,007) |
| Income tax expense (benefit) | 121 | (35) | 20 | - | 106 |
| Net income (loss) | \$(18,113) | \$(5,931) | \$ 2,347 | \$ 3,584 | \$(18,113) |

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

Six Months Ended June 30, 2011

| | Parent | Guarantor | Non-Guarantor | Eliminations | Consolidated |
|--|-------------|-----------|---------------|--------------|--------------|
| Cash flows from operating activities: | | | | | |
| Net income (loss) | \$ (3,274) | \$ 10,704 | \$ 3,083 | \$ (13,787) | \$ (3,274) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | | | |
| Depreciation, amortization and impairment | 567 | 11,723 | 429 | - | 12,719 |
| Share-based compensation | 986 | 1,086 | 48 | - | 2,120 |
| Change in contingent consideration for acquisitions | - | 128 | - | - | 128 |
| Amortization of notes payable issuance costs and discount | 1,156 | - | - | - | 1,156 |
| Provision for doubtful accounts receivable and sales returns, net of | - | 106 | 676 | - | 782 |

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|--|-----------|-----------|----------|-----------|---------------|
| recoveries | | | | | |
| Deferred income taxes | 628 | 87 | 1,725 | - | 2,440 |
| Realized gain on sale of equity security | - | - | (405) | - | (405) |
| Net change in assets and liabilities (net of effects of acquisitions) | (12,813) | (11,056) | (4,157) | 13,787 | (14,239) |
| Net cash provided by (used in) operating activities | (12,750) | 12,778 | 1,399 | - | 1,427 |
| Cash flows from investing activities: | | | | | |
| Acquisitions, net of cash acquired | - | (600) | - | - | (600) |
| Purchases of property, equipment, and leasehold improvements | - | (1,277) | - | - | (1,277) |
| Intercompany advances | 18,750 | (2,250) | - | (16,500) | - |
| Change in restricted cash | 80 | 800 | - | - | 880 |
| Distribution from investment in equity security | - | - | 405 | (16,500) | 405 |
| Net cash provided by (used in) investing activities | 18,830 | (3,327) | 405 | 26,202 | (592) |
| Cash flows from financing activities: | | | | | |
| Intercompany advances | - | (14,910) | (1,590) | 16,500 | - |
| Proceeds from issuance of term notes | 53,560 | - | - | - | 53,560 |
| Note issuance costs paid | (1,528) | - | - | - | (1,528) |
| Proceeds from exercise of stock options and employee stock purchase plan | 206 | - | - | - | 206 |
| Principal payments on capital leases | - | (41) | - | - | (41) |
| Redemption and retirement of preferred stock | (40,750) | - | - | - | (40,750) |
| Preferred stock dividends | (7,152) | - | - | - | (7,152) |
| Net cash provided by (used in) financing activities | 4,336 | (14,951) | (1,590) | 16,500 | 4,295 |
| Net increase (decrease) in cash and cash equivalents | 10,416 | (5,500) | 169 | - | 5,085 |
| Cash and cash equivalents (net of restricted cash), beginning of period | 186 | 34,914 | 4,282 | - | 39,382 (1) |
| Cash and cash equivalents (net of restricted cash), end of period | \$ 10,602 | \$ 29,414 | \$ 4,451 | \$ - | \$ 44,467 (2) |

(1) Net of restricted cash of \$1,647 at December 31, 2010

(2) Net of restricted cash of \$767 at June 30, 2011

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

| | Six Months Ended June 30, 2010 | | | | Consolidated |
|--|--------------------------------|-------------|---------------|--------------|--------------|
| | Parent | Guarantor | Non-Guarantor | Eliminations | |
| Cash flows from operating activities: | | | | | |
| Net income (loss) | \$ (18,113) | \$ (5,931) | \$ 2,347 | \$ 3,584 | \$ (18,113) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | | | |
| Depreciation, amortization and impairment | 1,514 | 6,796 | 416 | - | 8,726 |
| Share-based compensation | 257 | 412 | 147 | - | 816 |
| Change in contingent consideration for acquisitions | - | 342 | - | - | 342 |
| Amortization of notes payable issuance costs and discount | 452 | - | - | - | 452 |
| Provision for doubtful accounts receivable and sales returns, net of recoveries | - | (384) | 107 | - | (277) |
| Net change in assets and liabilities (net of effects of acquisitions) | 5,454 | 8,587 | (536) | (3,584) | 9,921 |
| Net cash provided by (used in) operating activities | (10,436) | 9,822 | 2,481 | - | 1,867 |
| Cash flows from investing activities: | | | | | |
| Cash paid for acquisitions, net of cash acquired | (208,876) | (1,350) | - | - | (210,226) |
| Purchases of property, equipment, and leasehold improvements | (7) | (611) | (127) | - | (745) |
| Intercompany advances | (13,350) | - | - | 13,350 | - |
| Change in restricted cash | - | 42 | - | - | 42 |
| Distribution from investment in equity security | - | - | 76 | - | 76 |
| Net cash used in investing activities | (222,233) | (1,919) | (51) | 13,350 | (210,853) |
| Cash flows from financing activities: | | | | | |
| Intercompany advances | - | 14,645 | (1,295) | (13,350) | - |
| | 194,532 | - | - | - | 194,532 |

| | | | | | |
|---|-----------|-----------|----------|-----------|---------------|
| Proceeds from issuance of notes payable, net of discount of \$5,468 | | | | | |
| Proceeds from issuance of stock | 41,750 | - | - | - | 41,750 |
| Note and stock issuance costs paid | (8,946) | - | - | - | (8,946) |
| Proceeds from employee stock purchase plan | 57 | - | - | - | 57 |
| Principal payments on capital leases | - | (48) | - | - | (48) |
| Net cash provided by (used in) financing activities | 227,393 | 14,597 | (1,295) | (13,350) | 227,345 |
| Net increase (decrease) in cash and cash equivalents | (5,276) | 22,500 | 1,135 | - | 18,359 |
| Cash and cash equivalents (net of restricted cash), beginning of period | 5,113 | 8,792 | 5,157 | - | 19,062 (1) |
| Cash and cash equivalents (net of restricted cash), end of period | \$ (163) | \$ 31,292 | \$ 6,292 | \$ - | \$ 37,421 (2) |

(1) Net of restricted cash of \$559 at December 31, 2009.

(2) Net of restricted cash of \$517 at June 30, 2010.

(14) Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. ASU No. 2011-05 amends the FASB Accounting Standards Codification (Codification) to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments to the Codification in the ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU No. 2011-05 will be applied retrospectively and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. We have not early adopted this ASU. Our adoption of this amendment will only impact the presentation of comprehensive income in our consolidated condensed financial statements.

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements. This ASU represents the converged guidance of the FASB and the International Accounting Standards Board (the Boards) on fair value measurement. The collective efforts of the Boards and their staffs, reflected in ASU 2011-04, have resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term "fair value." The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and International Financial Reporting Standards. The amendments to this ASU are to be applied prospectively. ASU No. 2011-04 is effective during interim and annual periods beginning after December 15, 2011. The adoption of this

amendment will affect our disclosures only and will not have a material impact on our statement of operations or financial position.

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Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

(15) Subsequent Event

On August 4, 2011, we completed our acquisition of Ophthalmic Imaging Systems (OIS). Under the terms set forth in the Agreement and Plan of Merger entered into with OIS on June 5, 2011, each share of OIS common stock was converted into the right to receive 0.1693 shares of Merge common stock. We issued approximately 5,132,000 shares in connection with the transaction. Based on the \$5.68 per share price of Merge common stock as of the close of trading on August 4, 2011, the aggregate value of Merge common stock issued as consideration was approximately \$29,150.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Note Regarding Forward-Looking Statements

The discussion below contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act, and Section 21E of the Exchange Act. We have used words such as “believes,” “intends,” “anticipates,” “expects” and similar expressions to identify forward-looking statements. These statements are based on information currently available to us and are subject to a number of risks and uncertainties that may cause our actual results of operations, financial condition, cash flows, performance, business prospects and opportunities and the timing of certain events to differ materially from those expressed in, or implied by, these statements. These risks, uncertainties and other factors include, without limitation, those matters discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2010. Except as expressly required by the federal securities laws, we undertake no obligation to update such factors or to publicly announce the results of any of the forward-looking statements contained herein to reflect future events, developments, or changed circumstances, or for any other reason. The following discussion should be read in conjunction with our consolidated financial statements and notes thereto appearing in our Annual Report on Form 10-K and Item 1A, “Risk Factors” for the year ended December 31, 2010.

Management’s Discussion and Analysis is presented in the following order:

- Overview
- Results of Operations
- Liquidity and Capital Resources
- Material Off Balance Sheet Arrangements
- Critical Accounting Policies

Overview

Our solutions are designed to help solve some of the toughest challenges in health information exchange today, such as the incorporation of medical images and diagnostic information into broader healthcare IT applications and the interoperability of proprietary software solutions. Our ability to innovate has driven consistent expansion of solutions and services and entry into new markets. We also look to expand through strategic acquisitions that will allow us to further expand our addressable market and customer base.

We primarily generate revenue from the sale of perpetual software licenses, upgrading and/or renewing those licenses, hardware, professional services and maintenance. Except for maintenance, these contract elements comprise the majority of non-recurring revenue. Our backlog of non-recurring revenue was \$40.1 million as of June 30, 2011. Maintenance, which we renew annually with our customer base, is the primary component of recurring revenues. Recurring revenue also includes software licenses sold through contracts that are annually renewed and recognized ratably over the annual period and recorded as software revenue, revenues derived from SaaS offerings which are recorded as professional services revenue and Electronic Data Interchange (EDI) revenues which are recognized based on monthly transactional volumes. During the second quarter of 2011, recurring revenue was approximately 62.5% of total net sales.

Our solutions optimize processes for healthcare providers ranging in size from single-doctor practices to health systems, for the sponsors of clinical trials, for the medical device industry, for the healthcare commerce system and for consumers of healthcare. These solutions are licensed by more than 1,500 hospitals; 4,000 clinics and labs, 250 medical device manufacturers and have been used by 70% of the top pharmaceutical companies. We believe that we have an opportunity to grow revenues by expanding our solution footprint in existing customers, as only a small

percent currently have more than one of our solutions. With the benefit of a broad customer base and several product lines undergoing ongoing innovation, we also believe that we are well-positioned to continue to leverage technologies into new segments where customers see value. For example, as the push for Meaningful Use incentives drives adoption of Electronic Health Records, we envision this will create significant demand for our vendor-neutral archiving and iConnect access platforms to image enable those newly deployed systems. In order to take advantage of these opportunities, we began aggressively hiring sales and marketing personnel in the fourth quarter of 2010.

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Results of Operations

The following have significantly impacted the results of operations for the periods discussed herein:

- During 2010, we expanded our product offerings through the acquisition of AMICAS, Inc. (AMICAS), an image and information management solutions provider, which we acquired on April 28, 2010 as well as five other acquisitions. As a result of the timing of the completion of the acquisition of AMICAS, the comparability of the results of operations in the three and six months ended June 30, 2011 differ significantly from the same periods in 2010, which include only 2 months of AMICAS' results.
- We issued \$200.0 million of Senior Secured Notes (Notes) in April 2010 as part of the financing for the acquisition of AMICAS. The Notes were issued at 97.266% of the principal amount, are due in 2015 and bear interest at 11.75% of principal (payable on May 1st and November 1st of each year). In connection with the Notes, we incurred issuance costs of \$9.0 million. The three and six months ended June 30, 2011 include three months and six months, respectively, of interest expense and amortization of the original issuance discount and costs of the Notes, whereas the three and six months ended June 30, 2010 include two months and two months, respectively, of such expenses.
- In order to improve our long-term cash flow outlook, we issued additional Notes in June 2011 to redeem and retire our Series A Preferred Stock. We issued an additional \$52.0 million in Notes at 103.0% of the principal amount with terms identical to the existing Notes, including an 11.75% interest rate. We used these proceeds to retire all 41,750 outstanding shares of our Series A Preferred Stock at the face value of \$41.8 million and paid cumulative dividends of \$7.3 million (which were accruing at a 15% annually compounding rate). The three and six months ended June 30, 2011 include one month of interest expense and amortization of the premium and certain issuance costs, whereas the three and six months ended June 30, 2010 include no such expenses. Also, we incurred \$2.9 million in costs related to the issuance of the additional Notes, including \$1.4 million which was expensed in "other expense, net" of our statement of operations and \$1.5 million which was capitalized and will be amortized into interest expense over the remaining term of the Notes.

Three Months Ended June 30, 2011 Compared to the Three Months Ended June 30, 2010

The following table sets forth selected, summarized, unaudited, consolidated financial data for the periods indicated, as well as comparative data showing increases and decreases between the periods. All amounts, except percentages, are in thousands.

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| | Three Months Ended June 30, | | | | | | Change | | |
|---|-----------------------------|-------|----------|-------------|--------|---|-----------|--------|---|
| | 2011 | % | (1) 2010 | % | (1) \$ | % | | | |
| Net sales: | | | | | | | | | |
| Software and other | \$17,639 | 31.7 | % | \$6,592 | 22.7 | % | \$11,047 | 167.6 | % |
| Professional services | 10,515 | 18.9 | % | 5,631 | 19.4 | % | 4,884 | 86.7 | % |
| Maintenance and EDI | 27,438 | 49.4 | % | 16,780 | 57.9 | % | 10,658 | 63.5 | % |
| Total net sales | 55,592 | 100.0 | % | 29,003 | 100.0 | % | 26,589 | 91.7 | % |
| Cost of sales: | | | | | | | | | |
| Software and other | 4,681 | 26.5 | % | 1,690 | 25.6 | % | 2,991 | 177.0 | % |
| Professional services | 5,016 | 47.7 | % | 4,028 | 71.5 | % | 988 | 24.5 | % |
| Maintenance and EDI | 6,687 | 24.4 | % | 5,809 | 34.6 | % | 878 | 15.1 | % |
| Depreciation, amortization and impairment | 2,347 | 4.2 | % | 4,487 | 15.5 | % | (2,140) | -47.7 | % |
| Total cost of sales | 18,731 | 33.7 | % | 16,014 | 55.2 | % | 2,717 | 17.0 | % |
| Total gross margin | 36,861 | 66.3 | % | 12,989 | 44.8 | % | 23,872 | 183.8 | % |
| Gross margin by net sales category (3) | | | | | | | | | |
| Software and other | 12,958 | 73.5 | % | 4,902 | 74.4 | % | 8,056 | 164.3 | % |
| Professional services | 5,499 | 52.3 | % | 1,603 | 28.5 | % | 3,896 | 243.0 | % |
| Maintenance and EDI | 20,751 | 75.6 | % | 10,971 | 65.4 | % | 9,780 | 89.1 | % |
| Operating expenses: | | | | | | | | | |
| Sales and marketing | 7,853 | 14.1 | % | 4,189 | 14.4 | % | 3,664 | 87.5 | % |
| Product research and development | 7,017 | 12.6 | % | 5,752 | 19.8 | % | 1,265 | 22.0 | % |
| General and administrative | 8,264 | 14.9 | % | 5,591 | 19.3 | % | 2,673 | 47.8 | % |
| Acquisition-related expenses | 375 | 0.7 | % | 2,421 | 8.3 | % | (2,046) | -84.5 | % |
| Restructuring and other expenses | - | 0.0 | % | 3,483 | 12.0 | % | (3,483) | NM(2) | |
| Depreciation, amortization and impairment | 5,223 | 9.4 | % | 2,181 | 7.5 | % | 3,042 | 139.5 | % |
| Total operating costs and expenses | 28,732 | 51.7 | % | 23,617 | 81.4 | % | 5,115 | 21.7 | % |
| Operating income (loss) | 8,129 | 14.6 | % | (10,628) | -36.6 | % | 18,757 | -176.5 | % |
| Other expense, net | (7,788) | -14.0 | % | (4,275) | -14.7 | % | (3,513) | 82.2 | % |
| Income (loss) before income taxes | 341 | 0.6 | % | (14,903) | -51.4 | % | 15,244 | -102.3 | % |
| Income tax expense | 2,026 | 3.6 | % | 58 | 0.2 | % | 1,968 | NM(2) | |
| Net loss | (1,685) | -3.0 | % | (14,961) | -51.6 | % | 13,276 | -88.7 | % |
| Less: preferred stock dividends | 1,587 | 2.9 | % | 15,944 | 55.0 | % | (14,357) | -90.0 | % |
| Net loss available to common shareholders | \$(3,272) | -5.9 | % | \$(30,905) | -106.6 | % | \$27,633 | -89.4 | % |

Percentages are of total net sales, except for cost of sales and gross margin, which are based (1) upon related net sales.
(2) NM denotes percentage is not meaningful.

(3) Depreciation and amortization expenses are excluded from these gross margin calculations.

Net Sales

Software and Other Sales. Total software and other sales in 2011 were \$17.6 million, an increase of \$11.0 million, or 167.6%, from \$6.6 million in 2010, primarily due to sales arising from the acquisition of AMICAS. We anticipate that the revenue recognized from software and other sales may vary significantly on a quarterly basis.

Professional Services Sales. Total professional services sales in 2011 were \$10.5 million, an increase of \$4.9 million, or 86.7%, from \$5.6 million in 2010, primarily due to sales arising from the acquisition of AMICAS.

Maintenance and EDI Sales. Total maintenance and EDI sales in 2011 were \$27.4 million, an increase of \$10.6 million, or 63.5%, from \$16.8 million in 2010, due to sales arising from the acquisition of AMICAS.

Gross Margin

Gross Margin – Software and Other Sales. Gross margin on software and other sales was \$13.0 million in 2011, an increase of \$8.1 million, or 164.3%, from \$4.9 million in 2010 primarily due to the increase in sales arising from the acquisition of AMICAS. Gross margin as a percentage of software and other sales was comparable in 2011 to 2010, as hardware sales, which are at lower margins than software only sales, were comparable between the periods. Hardware sales were 17% of software and other sales in 2011 compared to 18% in 2010. We expect gross margin on software and other sales to fluctuate depending on the mix of sales among our products, and expect such sales to include a greater mix of hardware for the remainder of 2011.

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Gross Margin – Professional Service Sales. Gross margin on professional service sales was \$5.5 million in 2011, an increase of \$3.9 million, or 243.0%, from \$1.6 million in 2010. Gross margin as a percentage of professional service sales increased to 52.3% in 2011 from 28.5% in 2010, primarily due to an increase in the billable utilization of our professional services resources. As the majority of professional services costs are fixed, we expect gross margins going forward to fluctuate depending on billable utilization of these resources.

Gross Margin – Maintenance and EDI Sales. Gross margin on maintenance and EDI sales was \$20.8 million in 2011, an increase of \$9.8 million, or 89.1%, from \$11.0 million in 2010. Gross margin as a percentage of maintenance and EDI sales increased to 75.6% in 2011 from 65.4% in 2010, primarily due to a reduction in third party maintenance costs.

Depreciation, Amortization and Impairment. Depreciation, amortization and impairment expense decreased \$2.1 million, or 47.7%, to \$2.4 million in 2011 from \$4.5 million in 2010, primarily due to a \$2.3 million impairment charge in 2010 related to our purchased software assets and involving overlapping products.

Sales and Marketing

Sales and marketing expense increased \$3.7 million, or 87.5%, to \$7.9 million in 2011 from \$4.2 million in 2010, primarily due to the acquisition of AMICAS. We expect that our quarterly sales and marketing expenses will continue to increase in 2011 as we invest further in these functions.

Product Research and Development

Product research and development expense increased \$1.3 million, or 22.0%, to \$7.0 million in 2011 from \$5.7 million in 2010, primarily due to the acquisition of AMICAS. As a percentage of net sales, product research and development decreased by 7.2% to 12.6% as we were able to leverage our innovation efforts. We expect that our quarterly product research and development expense will increase in 2011 as we invest and grow these functions to allow us to innovate and expand our product solution capabilities.

General and Administrative

General and administrative expense increased \$2.7 million, or 47.8%, to \$8.3 million in 2011 from \$5.6 million in 2010, primarily due to the acquisition of AMICAS. As a percentage of net sales, general and administrative expenses decreased by 4.4% to 14.9% as a result of the cost saving initiatives which were implemented in connection with the acquisition of AMICAS. These savings were offset by \$0.7 million of bonus expense accrued in 2011 based on operational performance to date. We expect to leverage our current level of general and administrative operations during 2011.

Acquisition-Related Expenses

Acquisition-related expenses are costs incurred to effect business combinations, including banking, legal, accounting, valuation and other professional or consulting fees. In 2010, we incurred \$2.4 million of acquisition-related expenses due to our acquisition of AMICAS.

Restructuring and Other Expenses

Restructuring and other expenses consist primarily of severance to involuntarily terminated employees resulting from our restructuring initiatives, abandonment of non-cancelable building leases and the relocation of employees associated with restructuring activities. In 2010, we incurred \$3.5 million of such expenses primarily related to the

reorganization of our business concurrent with our acquisition of AMICAS.

Depreciation, Amortization and Impairment

Depreciation, amortization and impairment expense increased \$3.0 million, or 139.5%, to \$5.2 million in 2011 from \$2.2 million in 2010, primarily due to a \$2.8 million charge for the impairment of trade names associated with certain products upon completion of a product rebranding initiative in the second quarter of 2011.

Other Expense, Net

Net other expense increased \$3.5 million, or 82.2%, to \$7.8 million in 2011 from \$4.3 million in 2010. In 2011 we incurred \$6.7 million of interest expense and amortization of issuance costs and note discount associated with our Notes and \$1.4 million in debt issue costs related to the additional \$52 million in Notes issued in June of 2011. In 2010, we incurred \$4.3 million of interest expense and amortization of issuance costs and note discount associated with our Notes which were issued in April of 2010.

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Income Tax Expense

In 2011, we recorded income tax expense of \$2.0 million. The effective tax rate for 2011 differs significantly from the statutory rate primarily due to non-cash income tax expense being recorded for profitable foreign operations that cannot be offset by unprofitable U.S. domestic operations requiring a full valuation allowance. The effective tax rate for 2010 differed from the statutory rate primarily due to the effect of changes in valuation allowances in both our primary foreign and domestic tax jurisdictions. Our expected effective income tax rate is volatile and may move up or down with changes in, among other items, operating income and the results of changes in tax laws and regulations of the U.S. and the foreign jurisdictions in which we operate.

Six Months Ended June 30, 2011 Compared to the Six Months Ended June 30, 2010

The following table sets forth selected, summarized, unaudited, consolidated financial data for the periods indicated, as well as comparative data showing increases and decreases between the periods. All amounts, except percentages, are in thousands.

| | 2011 | Six Months Ended June 30, | | (1) 2010 | | Change | | | |
|---|----------|---------------------------|---|-----------|-------|--------|----------|--------|---|
| | | % | % | (1) \$ | % | (1) \$ | % | | |
| Net sales: | | | | | | | | | |
| Software and other | \$36,310 | 33.5 | % | \$15,957 | 32.6 | % | \$20,353 | 127.5 | % |
| Professional services | 18,915 | 17.5 | % | 9,377 | 19.1 | % | 9,538 | 101.7 | % |
| Maintenance and EDI | 53,039 | 49.0 | % | 23,639 | 48.3 | % | 29,400 | 124.4 | % |
| Total net sales | 108,264 | 100.0 | % | 48,973 | 100.0 | % | 59,291 | 121.1 | % |
| Cost of sales: | | | | | | | | | |
| Software and other | 11,258 | 31.0 | % | 2,394 | 15.0 | % | 8,864 | 370.3 | % |
| Professional services | 10,079 | 53.3 | % | 7,025 | 74.9 | % | 3,054 | 43.5 | % |
| Maintenance and EDI | 14,651 | 27.6 | % | 7,306 | 30.9 | % | 7,345 | 100.5 | % |
| Depreciation, amortization and impairment | 4,846 | 4.5 | % | 5,705 | 11.6 | % | (859) | -15.1 | % |
| Total cost of sales | 40,834 | 37.7 | % | 22,430 | 45.8 | % | 18,404 | 82.1 | % |
| Total gross margin | 67,430 | 62.3 | % | 26,543 | 54.2 | % | 40,887 | 154.0 | % |
| Gross margin by net sales category (3) | | | | | | | | | |
| Software and other | 25,052 | 69.0 | % | 13,563 | 85.0 | % | 11,489 | 84.7 | % |
| Professional services | 8,836 | 46.7 | % | 2,352 | 25.1 | % | 6,484 | 275.7 | % |
| Maintenance and EDI | 38,388 | 72.4 | % | 16,333 | 69.1 | % | 22,055 | 135.0 | % |
| Operating expenses: | | | | | | | | | |
| Sales and marketing | 16,546 | 15.3 | % | 7,008 | 14.3 | % | 9,538 | 136.1 | % |
| Product research and development | 13,769 | 12.7 | % | 9,008 | 18.4 | % | 4,761 | 52.9 | % |
| General and administrative | 14,854 | 13.7 | % | 9,442 | 19.3 | % | 5,412 | 57.3 | % |
| Acquisition-related expenses | 479 | 0.4 | % | 8,359 | 17.1 | % | (7,880) | -94.3 | % |
| Restructuring and other expenses | (36) | 0.0 | % | 3,483 | 7.1 | % | (3,519) | -101.0 | % |
| Depreciation, amortization and impairment | 7,873 | 7.3 | % | 3,021 | 6.2 | % | 4,852 | 160.6 | % |
| Total operating costs and expenses | 53,485 | 49.4 | % | 40,321 | 82.3 | % | 13,164 | 32.6 | % |
| Operating income (loss) | 13,945 | 12.9 | % | (13,778) | -28.1 | % | 27,723 | -201.2 | % |

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| | | | | | | | | | |
|--|------------|-------|---|-------------|-------|---|-----------|-------|-------|
| Other expense, net | (14,348) | -13.3 | % | (4,229) | -8.6 | % | (10,119) | 239.3 | % |
| Income (loss) before income taxes | (403) | -0.4 | % | (18,007) | -36.8 | % | 17,604 | | NM(2) |
| Income tax expense | 2,871 | 2.7 | % | 106 | 0.2 | % | 2,765 | | NM(2) |
| Net loss | (3,274) | -3.0 | % | (18,113) | -37.0 | % | 14,839 | -81.9 | % |
| Less: preferred stock dividends | 3,153 | 2.9 | % | 15,944 | 32.6 | % | (12,791) | -80.2 | % |
| Net income (loss) available to common shareholders | \$(6,427) | -5.9 | % | \$(34,057) | -69.5 | % | \$27,630 | -81.1 | % |

(1) Percentages are of total net sales, except for cost of sales and gross margin, which are based upon related net sales.

(2) NM denotes percentage is not meaningful.

Depreciation, amortization and impairment expenses are excluded from

(3) these gross margin calculations.

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Net Sales

Software and Other Sales. Total software and other sales in 2011 were \$36.3 million, an increase of \$20.3 million, or 127.5%, from \$16.0 million in 2010, primarily due to sales arising from the acquisition of AMICAS. We anticipate that the revenue recognized from software and other sales may vary significantly on a quarterly basis.

Professional Services Sales. Total professional services sales in 2011 were \$18.9 million, an increase of \$9.5 million, or 101.7%, from \$9.4 million in 2010, primarily due to sales arising from the acquisition of AMICAS.

Maintenance and EDI Sales. Total maintenance and EDI sales in 2011 were \$53.0 million, an increase of \$29.4 million, or 124.4%, from \$23.6 million in 2010 due to sales arising from the acquisition of AMICAS.

Gross Margin

Gross Margin – Software and Other Sales. Gross margin on software and other sales was \$25.1 million in 2011, an increase of \$11.5 million, or 84.7%, from \$13.6 million in 2010. Gross margin as a percentage of software and other sales decreased to 69.0% in 2011 compared to 85.0% in 2010, due to an increase in hardware sales, which are at lower margins than software only sales, as a result of the acquisition of AMICAS. Hardware sales were 24% of software and other sales in 2011 compared to 10% in 2010.

Gross Margin – Professional Service Sales. Gross margin on professional service sales was \$8.8 million in 2011, an increase of \$6.5 million, or 275.7%, from \$2.3 million in 2010. Gross margin as a percentage of professional service sales increased to 46.7% in 2011 from 25.1% in 2010, primarily due to an increase in the billable utilization of our professional services resources.

Gross Margin – Maintenance and EDI Sales. Gross margin on maintenance and EDI sales was \$38.4 million in 2011, an increase of \$22.1 million, or 135.0%, from \$16.3 million in 2010. Gross margin as a percentage of maintenance and EDI sales increased to 72.4% in 2011 from 69.1% in 2010, primarily due to a reduction in third party maintenance costs.

Depreciation, Amortization and Impairment. Depreciation, amortization and impairment expense decreased \$0.9 million, or 15.1%, to \$4.8 million in 2011 from \$5.7 million in 2010, primarily due to a \$2.3 impairment charge in 2010 related to our purchased software assets and involving overlapping products, offset by an increase due to the acquisition of AMICAS in 2010.

Sales and Marketing

Sales and marketing expense increased \$9.5 million, or 136.1%, to \$16.5 million in 2011 from \$7.0 million in 2010, primarily due to the acquisition of AMICAS. As a percentage of net sales, sales and marketing expense increased by 1.0% to 15.3% as a result of our investments in these functions.

Product Research and Development

Product research and development expense increased \$4.8 million, or 52.9%, to \$13.8 million in 2011 from \$9.0 million in 2010, primarily due to the acquisition of AMICAS. As a percentage of net sales, product research and development decreased by 5.7% to 12.7% as we were able to leverage our innovation efforts.

General and Administrative

General and administrative expense increased \$5.4 million, or 57.3%, to \$14.8 million in 2011 from \$9.4 million in 2010, primarily due to the acquisition of AMICAS. As a percentage of net sales, general and administrative expenses decreased by 5.6% to 13.7% as a result of the cost saving initiatives which were implemented in connection with the acquisition of AMICAS. These savings were offset by \$1.1 million of bonus expense accrued in 2011 based on operational performance to date.

Acquisition-Related Expenses

Acquisition-related expenses are costs incurred to effect business combinations, including banking, legal, accounting, valuation and other professional or consulting fees. In 2010, we incurred \$8.4 million of acquisition-related expenses primarily due to our acquisition of AMICAS.

Restructuring and Other Expenses

Restructuring and other expenses consist primarily of severance to involuntarily terminated employees resulting from our restructuring initiatives, abandonment of non-cancelable building leases and the relocation of employees associated with restructuring activities. In 2010, we incurred \$3.5 million of such expenses, primarily related to the reorganization of our business concurrent with our acquisition of AMICAS.

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Depreciation, Amortization and Impairment

Depreciation, amortization and impairment expense increased \$4.9 million, to \$7.9 million in 2011 from \$3.0 million in 2010, primarily due to the acquisition of AMICAS as well as a \$2.8 million charge for the impairment of trade names associated with certain products upon completion of a product rebranding initiative in the second quarter of 2011.

Other Expense, Net

Net other expense increased \$10.1 million, to \$14.3 million in 2011 from \$4.2 million in 2010. In 2011 we incurred \$13.1 million of interest expense and amortization of issuance costs and note discount associated with our Notes and \$1.4 million in debt issue costs related to the additional \$52 million in Notes issued in June 2011. In 2010, we incurred \$4.3 million of interest expense and amortization of issuance costs and note discount associated with our Notes which were issued in April of 2010.

Income Tax Expense

In 2011, we recorded income tax expense of \$2.9 million. The effective tax rate for 2011 differs significantly from the statutory rate primarily due to non-cash income tax expense being recorded for profitable foreign operations that cannot be offset by unprofitable U.S. domestic operations requiring a full valuation allowance. The effective tax rate for 2010 differed from the statutory rate primarily due to the effect of changes in valuation allowances in both our primary foreign and domestic tax jurisdictions. Our expected effective income tax rate is volatile and may move up or down with changes in, among other items, operating income and the results of changes in tax laws and regulations of the U.S. and the foreign jurisdictions in which we operate.

Liquidity and Capital Resources

Our cash and cash equivalents were \$45.2 million at June 30, 2011, an increase of approximately \$4.2 million, or 10.2%, from our balance of \$41.0 million at December 31, 2010. In addition, our working capital was \$46.0 million at June 30, 2011, an increase of \$17.2 million from our working capital of \$28.8 million at December 31, 2010.

The change in cash and cash equivalents, including restricted cash, during the six month periods ended June 30, 2011 and 2010 is attributed to the following factors:

| | Six Months Ended June 30, | |
|---------------------------------------|---------------------------|----------|
| | 2011 | 2010 |
| | (unaudited) | |
| | (amounts in millions) | |
| Cash received from (paid for): | | |
| Issuance of debt and equity | \$ 53.6 | \$ 236.3 |
| Debt and equity issuance costs | (2.5) | (8.9) |
| Redemption of preferred stock | (40.8) | - |
| Payments of preferred stock dividends | (7.1) | - |
| Interest paid, net | (10.9) | - |
| Acquisitions | (0.6) | (210.2) |
| Restructuring initiatives | (0.9) | (1.4) |
| Acquisition related costs, net | (0.4) | (7.1) |
| Property and equipment purchases | (1.2) | (0.8) |
| Settlements with former officers | (0.9) | - |

| | | |
|--|--------|---------|
| Other non-operating cash flows | 0.4 | 0.2 |
| Core business operations | 15.5 | 10.2 |
| Increase in cash (including restricted cash) | \$ 4.2 | \$ 18.3 |

Operating Cash Flows

Cash provided by operating activities was \$1.4 million in 2011, compared to \$1.9 million in 2010. The net loss in 2011 of \$3.3 million includes non-cash expenses of \$18.9 million, which were offset by changes in operating assets and liabilities in 2011 that reduced operating cash flows by \$14.2 million.

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In addition to the payments related to restructuring initiatives as noted in the table above, we have remaining payments due as of June 30, 2011 of \$1.3 million.

Investing Cash Flows

In the six months ended June 30, 2011, we paid \$0.6 million for an insignificant acquisition and acquired \$1.3 million in fixed assets, offset by a \$0.9 million decrease in restricted cash.

Financing Cash Flows

In June 2011, we issued \$52.0 million in additional Notes at 103.0% of the principal amount with terms identical to the existing Notes. Prior to issuance, we received consents from the majority of holders of existing Notes to amend the Indenture to allow us to incur the additional indebtedness. As consideration for the consents, we paid \$1.5 million in consent fees from the proceeds of the Notes. The proceeds of these additional Notes were used to redeem and retire our Series A Preferred Stock at the face value of \$41.8 million and to pay associated dividends of \$7.3 million. We paid all but \$1.2 million of the redemption payments as of June 30, 2011, with the remaining amounts paid in July 2011.

Contractual Obligations

Total outstanding commitments as of June 30, 2011 were as follows (in thousands):

| Contractual Obligations | Total | Less than 1 Year | Payment due by period | | |
|-------------------------------------|-----------|---------------------|-----------------------|-------------|----------------------|
| | | | 1 – 3 Years | 3 – 5 Years | More than 5 Years |
| Operating leases | \$21,230 | \$4,349 | \$5,002 | \$3,154 | \$8,725 |
| Capital leases (including interest) | 22 | 21 | 1 | - | - |
| Notes payable (including interest) | 370,440 | 29,610 | 59,220 | 281,610 | - |
| Total | \$391,692 | \$33,980 | \$64,223 | \$284,764 | \$8,725 |

The above obligations include lease payments involving facilities that we use and those we have either ceased to use or previously abandoned.

Except for restricted cash of \$0.8 million (primarily letters-of-credit related to our leased facilities) and a \$0.8 million guarantee to a lender on behalf of a customer at June 30, 2011, we do not have any other significant long-term obligations, contractual obligations, lines of credit, standby letters of credit, guarantees, standby repurchase obligations or other commercial commitments.

General

We believe our current cash and cash equivalent balances will be sufficient to meet our operating, financing and capital requirements through at least the next 12 months, including interest payments due under the Notes. However, any projections of future cash inflows and outflows are subject to uncertainty. In the event that it is necessary to raise additional capital to meet our short term or long term liquidity needs, such capital may be raised through additional debt, equity offerings or sale of certain assets. If we raise additional funds through the issuance of equity, equity-related or debt securities, such securities may have rights, preferences or privileges senior to those of our common stock. Furthermore, the number of shares of any new equity or equity-related securities that may be issued may result in significant dilution to existing shareholders. In addition, the issuance of debt securities could increase the liquidity risk or perceived liquidity risk that we face. We cannot, however, be certain that additional financing, or

funds from asset sales, will be available on acceptable terms. If adequate funds are not available or are not available on acceptable terms, we will likely not be able to take advantage of opportunities, develop or enhance services or products or respond to competitive pressures. Any projections of future cash inflows and outflows are subject to uncertainty. In particular, our uses of cash in 2011 and beyond will depend on a variety of factors such as the costs to implement our business strategy, the amount of cash that we are required to devote to defend and address any regulatory proceedings, and potential merger and acquisition activities.

For a more detailed description of risks and uncertainties that may affect our liquidity, see Item 1A., "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2010.

Material Off Balance Sheet Arrangements

We have no material off balance sheet arrangements.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires our management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, our management evaluates these estimates. We base our estimates and judgments on our experience, our current knowledge (including terms of existing contracts), our beliefs of what could occur in the future, our observation of trends in the industry, information provided by our customers and information available from other sources. Actual results may differ materially from these estimates.

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We have identified the following accounting policies and estimates as those that we believe are most critical to our financial condition and results of operations and that require management's most subjective and complex judgments in estimating the effect of inherent uncertainties: revenue recognition, allowance for sales returns and doubtful accounts, intangible assets and goodwill, share-based compensation expense, income taxes, guarantees and loss contingencies. There have been no significant changes in the quarterly period ended June 30, 2011 in our method of application of these critical accounting policies. For a complete description of our critical accounting policies, please refer to Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies" in our Annual Report on Form 10-K for the year ended December 31, 2010.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our cash and cash equivalents are exposed to financial market risk due to fluctuations in interest rates, which may affect our interest income. As of June 30, 2011, our cash and cash equivalents included money market funds and short term deposits totaling \$45.2 million, and earned interest at a weighted average rate of approximately 0.1%. The value of the principal amounts is equal to the fair value for these instruments. Due to the relative short-term nature of our investment portfolio, our interest income is vulnerable to changes in short-term interest rates. At current investment levels, our results of operations would vary by approximately \$0.5 million on an annual basis for every 100 basis point change in our weighted average short-term interest rate. We do not use our portfolio for trading or other speculative purposes.

Foreign Currency Exchange Risk

We have sales and expenses in Canada, China and Europe that are denominated in currencies other than the U.S. dollar and, as a result, have exposure to foreign currency exchange risk. In the event our exposure to foreign currency exchange risk increases to levels that we do not deem acceptable, we may choose to hedge those exposures. We did not enter into any derivative financial instruments to hedge such exposures in 2011 or 2010.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures, which were designed to provide reasonable assurance of achieving their objectives, as of June 30, 2011, as required by Rule 13a-15 of the Exchange Act. This evaluation was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer. Based on this evaluation, our principal executive officer and principal financial officer have concluded that, as of June 30, 2011, our disclosure controls and procedures were effective at the reasonable assurance level to ensure (1) that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and (2) information required to be disclosed by us in our reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes with respect to our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting in the quarterly period ended June

30, 2011.

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings

On June 1, 2009, Merge Healthcare was sued in the Milwaukee County Circuit Court, State of Wisconsin, by William C. Mortimore and David M. Noshay with respect to the separation of Mortimore's and Noshay's employment and our subsequent refusal to indemnify them with respect to litigation related to their services as officers of Merge. The plaintiffs allege that we breached their employment agreements, unreasonably refused their requests for indemnification and breached other covenants of good faith and fair dealing. The plaintiffs seek indemnification and unspecified monetary damages. Discovery in this case is on-going. On April 6, 2011, the Milwaukee County Circuit Court rendered a decision in which it concluded that Merge and Mortimore had entered into an oral employment contract on or about June 15, 2006, but the Court did not make any decision as to damages, which would be addressed in a later phase of the litigation. On May 9, 2011, Merge appealed the Circuit Court's decision. The appeal is ongoing and the Circuit Court litigation has been stayed pending appeal. We have retained litigation counsel, intend to continue to defend this action vigorously and have filed a counterclaim for fraud, among other claims, against both Mortimore and Noshay. We will also continue to pursue the appeal.

In January 2010, a purported stockholder class action complaint was filed in the Superior Court of Suffolk County, Massachusetts in connection with AMICAS Inc.'s (AMICAS) proposed acquisition by Thoma Bravo, LLC (the "Thoma Bravo Merger"). A second similar action was filed in the same Court in February 2010 and consolidated with the first action. In March 2010, because AMICAS had terminated the Thoma Bravo Merger and agreed to be acquired by us, the Court dismissed the plaintiffs' claims as moot. Subsequently, counsel for the plaintiffs filed an application for approximately \$5 million of attorneys' fees for its work on this case, which fee petition AMICAS opposed. We retained litigation counsel to defend against the fee petition. On December 4, 2010, the Court awarded plaintiffs approximately \$3.2 million in attorneys' fees and costs. AMICAS has filed a notice of appeal from this judgment, and the plaintiffs have cross-appealed. We previously tendered the defense in this matter to our appropriate insurers, who have provided coverage against the claims asserted against AMICAS. After receipt of the Court's attorneys' fee award decision, the applicable insurer denied policy coverage for approximately \$2.5 million of the fee award. We do not believe that the insurer's denial has merit and have retained counsel to contest it. We will vigorously assert all of our rights under our applicable insurance policies, which we believe cover the claims and expenses incurred by AMICAS or us in connection with the fee award. On June 6, 2011, the insurer filed an action against AMICAS, Inc. and Merge in Federal Court in the Northern District of Illinois seeking a declaration that it is not responsible for the \$2.5 million portion of the judgment rendered in the December 4, 2010 judgment from the Superior Court of Suffolk County, Massachusetts. Merge intends to file a counterclaim seeking a declaration that the insurer must pay the full amount of the Superior Court's fee award, plus additional damages. Merge intends to seek a dismissal of the insurer's action. However, an adverse outcome could negatively impact our financial condition.

On February 1, 2010, Merge filed a complaint against its former CEO, Richard Linden, and its former CFO, Scott Veech, in the U.S. District for the Eastern District of Wisconsin, seeking a declaration that we do not have to indemnify either Linden or Veech for liabilities they incurred in connection with SEC investigation and enforcement actions and various securities fraud and shareholder derivative litigation. Merge also seeks to recover from both defendants all costs incurred by Merge associated with defending Linden and Veech in those prior actions. On October 15, 2010, the Court concluded that it did not have subject matter jurisdiction over Merge's claims and dismissed the claims in their entirety. The Court rendered no opinion on the merits of Merge's claims. Merge is evaluating its further options with respect to the Scott Veech matter in Wisconsin state court. On February 8, 2011, Merge filed a complaint in the U.S. District Court for the Eastern District of Wisconsin captioned Merge Healthcare Incorporated v. Richard Linden, Case no. 11-CV-001541. On May 4, 2011, Merge and Linden entered into a confidential settlement agreement resolving all claims against Mr. Linden and through which Linden agreed to issue a statement of regret and apology to Merge's Board of Directors and reimburse Merge for a portion of the Company's

legal fees to defend Linden in prior legal actions. Merge believes that it has numerous meritorious claims against Mr. Veech and will continue to pursue these claims, which have not been affected by the settlement with Mr. Linden.

In August, 2010, Merge Healthcare was sued in the Northern District of Texas by the Court-appointed receiver for Stanford International Bank, Ltd. The receiver alleges that Merge was a recipient of a fraudulent conveyance as a result of a Ponzi scheme orchestrated by Robert Stanford and Stanford International Bank, Ltd. (SIBL). Merge is not alleged to have participated in the Ponzi scheme. The receiver's claims arise from the failed acquisition of Emageon, Inc. (Emageon) by Health Systems Solutions, Inc. (HSS), an affiliate of SIBL, in February 2009, which resulted in the payment of a \$9 million break-up fee by HSS, which payment is alleged to have been financed by SIBL. Merge subsequently acquired Emageon as part of our AMICAS acquisition. The complaint seeks to recover the \$9 million payment to Emageon, plus interest, costs, and attorneys' fees. We have retained litigation counsel and intend to vigorously defend this action. We have filed a motion to dismiss the complaint. That motion has been fully briefed, and we are awaiting a decision from the Court. However, an adverse outcome could negatively impact our operating results and financial condition.

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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. We are unable to estimate 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.

Item 1A. Risk Factors

Our operations and financial results are subject to various risks and uncertainties that could adversely affect our business, financial condition, results of operations, and the market price for our common stock. Part I, Item 1A, "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2010 includes a detailed discussion of these factors and these factors have not changed materially from those included in the Form 10-K, other than those set forth below.

We may be unable to integrate OIS' operations successfully or to achieve expected cost savings and unanticipated costs relating to the OIS acquisition could reduce our future earnings per share.

On August 4, 2011, we consummated our acquisition of OIS. Our earnings, financial condition and prospects after the acquisition of OIS will depend in part on our ability to integrate the operations and management of OIS and to continue to implement OIS' business plan. Among the issues that we could face in such integration are:

- unexpected problems with operations, personnel, technology or credit;
 - loss of customers and employees of OIS;
- potential difficulty in working with OIS' employees and customers;
 - the assimilation of OIS' operations, sites and personnel; and
- instituting and maintaining uniform standards, controls, procedures and policies.

Even if the integration of OIS is successful, it may not result in the realization of the full benefits of the synergies and growth opportunities that we currently expect or these benefits may not be achieved within the anticipated time frame. Any failure to timely realize these anticipated benefits could have a material adverse effect on our revenues, expenses and operating results.

Further, although we anticipate cost savings as a result of the acquisition, we may not be fully able to realize those savings. Any cost savings which are realized may be offset by losses in revenues or other charges to earnings.

We believe that we have reasonably estimated the likely costs of integrating the operations of OIS into our business and the incremental costs of operating as a combined company. However, it is possible that unexpected transaction costs or future operating expenses, as well as other types of unanticipated adverse developments, could have a material adverse effect on our results of operations and financial condition. If unexpected costs are incurred, the acquisition could have a dilutive effect on our earnings per share, meaning earnings per share could be less than if the acquisition had not been completed.

See also the discussions in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources" and Part I, Item 4, "Controls and Procedures" in this Quarterly Report on Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In April 2011, we issued 80,450 shares of common stock as partial consideration for an insignificant acquisition. These shares were issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended.

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Item 6. Exhibits

(a) Exhibits

See Exhibit Index

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Registrant:

MERGE HEALTHCARE INCORPORATED

August 9, 2011

By:

/s/ Jeffery A. Surges
Jeffery A. Surges
Chief Executive Officer
(principal executive officer)

August 9, 2011

By:

/s/ Justin C. Dearborn
Justin C. Dearborn
President and Chief Financial Officer
(principal financial officer)

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EXHIBIT INDEX

| | |
|-------------|--|
| 3.1 | Amended and Restated Certificate of Designation for Series A Preferred Stock, incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed with the SEC on June 8, 2011. |
| 4.1 | First Supplemental Indenture, dated June 14, 2011, among the Registrant, the guarantors party thereto and The Bank of New York Mellon Trust Company, N.A., incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed with the SEC on June 15, 2011. |
| 4.2 | Second Supplemental Indenture, dated June 20, 2011, among the Registrant, the guarantors party thereto and The Bank of New York Mellon Trust Company, N.A., incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed with the SEC on June 20, 2011. |
| 10.1 | Agreement and Plan of Merger, dated June 5, 2011, by and among the Registrant, ES Acquisition Corp. and Ophthalmic Imaging Systems, incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed with the SEC on June 6, 2011. |
| 10.2 | Registration Rights Agreement, dated June 20, 2011, among the Registrant, the guarantors party thereto and Morgan Stanley & Co. LLC, incorporated by reference to Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed with the SEC on June 20, 2011. |
| <u>31.1</u> | Certificate of Chief Executive Officer (principal executive officer) Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 |
| <u>31.2</u> | Certificate of Chief Financial Officer (principal accounting officer) Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 |
| <u>32</u> | Certificate of Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) Pursuant to Section 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS | XBRL Instance Document* |
| 101.SCH | XBRL Taxonomy Extension Schema Document* |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document* |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document* |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document* |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document* |

*In accordance with Rule 406T under Regulation S-T, the XBRL-related information in Exhibit 101 shall be deemed "furnished" and not "filed."