

NightHawk Radiology Holdings Inc  
Form 10-Q  
August 06, 2010  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2010**

**OR**

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

**Commission File Number 000-51786**

**NightHawk Radiology Holdings, Inc.**

(Exact name of registrant as specified in its charter)

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>87-0722777</b> (IRS Employer Identification No.)
<b>4900 N. Scottsdale Road, 6<sup>th</sup> Floor, Scottsdale, Arizona</b> (Address of principal executive offices)	<b>85251</b> (Zip code)
<b>(480) 822-4000</b> (Registrant's telephone number, including area code)	

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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

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

As of July 31, 2010, 23,738,092 shares of the Registrant's common stock were outstanding.

**Table of Contents**

**TABLE OF CONTENTS**

**Part I**

Item 1.	<u>Financial Statements</u>	3
	<u>Condensed Consolidated Statements of Operations</u>	3
	<u>Condensed Consolidated Balance Sheets</u>	4
	<u>Condensed Consolidated Statements of Cash Flows</u>	5
	<u>Condensed Consolidated Statements of Comprehensive Income (Loss)</u>	6
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	29
Item 4.	<u>Controls and Procedures</u>	30

**Part II**

Item 1.	<u>Legal Proceedings</u>	30
Item 1A.	<u>Risk Factors</u>	31
Item 6.	<u>Exhibits</u>	41
	<u>Signatures</u>	42

**Table of Contents****PART 1 FINANCIAL INFORMATION****Item 1. Financial Statements****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

(In thousands, except share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Service revenue</b>	\$ 33,560	\$ 36,760	\$ 65,165	\$ 70,342
<b>Operating costs and expenses:</b>				
Professional services	16,327	17,393	32,986	33,261
Sales, general, and administrative	13,538	13,211	26,666	25,224
Depreciation and amortization	1,894	1,833	3,779	3,749
Goodwill and intangible asset impairment				61,785
<b>Total operating costs and expenses</b>	<b>31,759</b>	<b>32,437</b>	<b>63,431</b>	<b>124,019</b>
<b>Operating income (loss)</b>	<b>1,801</b>	<b>4,323</b>	<b>1,734</b>	<b>(53,677)</b>
<b>Other income (expense):</b>				
Interest expense	(3,744)	(1,630)	(6,828)	(3,628)
Interest income	20	50	72	105
Other, net	21	(16)	31	(8)
<b>Total other income (expense)</b>	<b>(3,703)</b>	<b>(1,596)</b>	<b>(6,725)</b>	<b>(3,531)</b>
<b>Income (loss) from continuing operations before income taxes</b>	<b>(1,902)</b>	<b>2,727</b>	<b>(4,991)</b>	<b>(57,208)</b>
Income tax expense (benefit)	664	1,065	25	(10,186)
<b>Net income (loss) from continuing operations</b>	<b>(2,566)</b>	<b>1,662</b>	<b>(5,016)</b>	<b>(47,022)</b>
Net income (loss) from discontinued operations (Note 12)	(1,619)	432	(18,364)	(3,497)
<b>Net income (loss)</b>	<b>\$ (4,185)</b>	<b>\$ 2,094</b>	<b>\$ (23,380)</b>	<b>\$ (50,519)</b>
<b>Basic earnings (loss) per common share:</b>				
Basic net income (loss) per share from continuing operations	\$ (0.11)	\$ 0.06	\$ (0.21)	\$ (1.77)
Basic net income (loss) per share from discontinued operations	(0.07)	0.02	(0.78)	(0.13)
<b>Basic net income (loss) per common share</b>	<b>\$ (0.18)</b>	<b>\$ 0.08</b>	<b>\$ (0.99)</b>	<b>\$ (1.90)</b>
<b>Diluted earnings (loss) per common share:</b>				
Diluted net income (loss) per share from continuing operations	\$ (0.11)	\$ 0.06	\$ (0.21)	\$ (1.77)
Diluted net income (loss) per share from discontinued operations	(0.07)	0.02	(0.78)	(0.13)
<b>Diluted net income (loss) per common share</b>	<b>\$ (0.18)</b>	<b>\$ 0.08</b>	<b>\$ (0.99)</b>	<b>\$ (1.90)</b>

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

<b>Weighted averages of common shares outstanding:</b>				
Basic	23,671,256	26,490,880	23,624,158	26,569,576
Diluted	23,671,256	26,958,693	23,624,158	26,569,576

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(In thousands, except share data)

	June 30, 2010	December 31, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 24,311	\$ 26,293
Marketable securities		6,000
Trade accounts receivable, net	17,393	17,468
Notes receivable, current	4,609	
Deferred income taxes	2,426	1,022
Income tax receivable	11,626	2,215
Prepaid expenses and other current assets	3,357	1,922
Current assets of discontinued operations	1,492	4,344
<b>Total current assets</b>	<b>65,214</b>	<b>59,264</b>
Property and equipment, net	10,368	11,025
Intangible assets, net	20,287	22,190
Deferred income taxes	13,962	14,408
Notes receivable, non-current	8,173	
Other assets, net	2,069	4,646
Long-term assets of discontinued operations		54,141
<b>Total</b>	<b>\$ 120,073</b>	<b>\$ 165,674</b>
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable	\$ 6,166	\$ 6,130
Accrued expenses and other liabilities	3,506	3,160
Accrued payroll and related benefits	3,535	3,460
Long-term debt, due within one year	10,518	802
Current liabilities of discontinued operations	266	622
<b>Total current liabilities</b>	<b>23,991</b>	<b>14,174</b>
Insurance reserve	3,127	4,018
Long-term debt	41,287	77,404
Other liabilities	4,635	1,348
<b>Total liabilities</b>	<b>73,040</b>	<b>96,944</b>
Commitments and contingencies		
<b>STOCKHOLDERS EQUITY</b>		
Common stock 150,000,000 shares authorized; \$.001 par value; 23,717,467 and 23,558,890 shares issued and outstanding, respectively	24	24
Additional paid-in capital	222,247	221,106
Retained earnings (deficit)	(175,039)	(151,660)
Accumulated other comprehensive income (deficit)	(199)	(740)
<b>Total stockholders equity</b>	<b>47,033</b>	<b>68,730</b>

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Total	\$ 120,073	\$ 165,674
-------	------------	------------

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

(In thousands)

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (23,380)	\$ (50,519)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	6,920	5,513
Goodwill and intangible asset impairment	27,326	68,718
Amortization of debt issuance costs and effect of interest rate swaps	6,272	2,114
Deferred income taxes	(110)	(14,195)
Non-cash stock compensation expense	1,207	2,594
Other, net	61	636
Changes in operating assets and liabilities:		
Trade accounts receivable, net	(154)	844
Trade accounts receivable due from SPRPA	2,500	
Prepaid expenses and other assets	(1,170)	(1,899)
Income tax receivable	(9,410)	947
Accounts payable	238	389
Accrued expenses and other liabilities	95	(959)
Accrued payroll and related benefits	356	294
Net cash provided by operating activities	10,751	14,477
<b>Cash flows from investing activities:</b>		
Purchase of marketable securities		(4,990)
Proceeds from maturities of marketable securities	6,000	
Purchase of property and equipment	(1,769)	(2,156)
Termination fee received related to SPRPA settlement	7,500	
Proceeds from sale of business	2,000	
Net cash provided by (used in) investing activities	13,731	(7,146)
<b>Cash flows from financing activities:</b>		
Repayment of debt	(26,401)	(478)
Proceeds from exercise of stock options	55	50
Withholding taxes paid related to restricted stock net settlement	(121)	
Excess tax benefit from exercise of stock options	3	8
Purchase and retirement of common stock		(6,452)
Debt amendment costs		(434)
Cash exchange for stock options		(53)
Net cash used in financing activities	(26,464)	(7,359)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(1,982)</b>	<b>(28)</b>
<b>Cash and cash equivalents beginning of period</b>	<b>26,293</b>	<b>47,160</b>
<b>Cash and cash equivalents end of period</b>	<b>\$ 24,311</b>	<b>\$ 47,132</b>



## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

### Supplemental disclosures of cash flow information:

Cash paid for interest	\$ 2,121	\$ 2,336
Cash paid (refunded) for income taxes	(731)	1,654
<b>Non-cash investing and financing activities:</b>		
Purchases of equipment included in accounts payable	61	501
Termination fee related to SPRPA settlement included in notes receivable	12,782	

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (unaudited)****(In thousands)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Net income (loss)	\$ (4,185)	\$ 2,094	\$ (23,380)	\$ (50,519)
Other comprehensive income (loss):				
Change in fair value of interest rate swaps		2,781		3,276
Reclassification adjustments for net losses on interest rate swaps included in net income (loss)	612	884	894	1,768
Foreign currency translation adjustments	4	(30)	(13)	(75)
Less: deferred income taxes	(111)	(1,395)	(340)	(1,898)
Net other comprehensive income (loss)	505	2,240	541	3,071
Comprehensive income (loss)	\$ (3,680)	\$ 4,334	\$ (22,839)	\$ (47,448)

See Notes to Condensed Consolidated Financial Statements.

---

**Table of Contents**

**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation** The accompanying unaudited condensed consolidated financial statements include the results of operations, financial position and cash flows of NightHawk Radiology Holdings, Inc. and its subsidiaries (the Company). All material intercompany balances have been eliminated.

In the opinion of the Company's management, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary to present fairly, in all material respects, the Company's results for the periods presented. These condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such SEC rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in Item 8 of the Company's 2009 Annual Report on Form 10-K filed with the SEC on February 25, 2010. The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of results to be expected for the entire fiscal year.

On June 30, 2010, the Company settled a dispute with St. Paul Radiology, P.A. (SPRPA). In connection with the settlement, the Company sold to a third party its ownership interest in Midwest Physicians Services, LLC (MPS) and Emergency Radiology Services, LLC (ERS). Consequently, for all of the periods presented, income (loss) from these operations has been presented as net income (loss) from discontinued operations in the consolidated statements of operations. The assets and liabilities associated with MPS and ERS have been reclassified to assets of discontinued operations and liabilities of discontinued operations as of June 30, 2010 and December 31, 2009 on our accompanying consolidated balance sheet. Unless noted otherwise, discussions in these notes pertain to our continuing operations only. For more information on the closing of the transaction, see also Note 12 Discontinued Operations.

The Company's unaudited condensed consolidated balance sheet as of December 31, 2009 has been derived from the audited consolidated balance sheet as of that date. Certain information and footnote disclosure normally included in the Company's annual consolidated financial statements have been condensed or omitted.

**Use of Estimates** The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of these estimates require difficult, subjective or complex judgments about matters that are inherently uncertain. Actual results could differ from those estimates.

On an ongoing basis, the Company evaluates its estimates, including those related to the accounts receivable allowance, fair value of acquired intangible assets, useful lives of intangible assets and property and equipment, income taxes, the loss contingency for general and medical liability claims, reserves for incurred but not reported (IBNR) medical liability claims, for determining stock-based compensation, and the fair value of interest rate swap contracts.

**Trade Accounts Receivable** Trade accounts receivable represent receivables for services and are recorded at the invoiced amount and are non-interest bearing. Company management reviews past due accounts receivable to identify specific customers with known disputes or collectability issues. As of June 30, 2010 and December 31, 2009, the Company had reserved \$0.7 million and \$0.9 million, respectively, for doubtful accounts based on its estimate of the collectability of outstanding receivables as of those dates. When the Company determines that a receivable is not recoverable, the amount is removed from the financial records along with the corresponding reserve balance. During the three and six months ended June 30, 2010, the Company removed \$0.1 million and \$0.5 million, respectively, of specifically identified uncollectible accounts receivable and the corresponding reserves from its financial records.

**Notes Receivable** Notes receivable represents a \$14.0 million promissory note issued by SPRPA to the Company as partial consideration for the settlement. The note does not bear interest and pursuant to the terms of the note, SPRPA is obligated to make 48 equal installment payments of \$250,000 starting in August 2010 and continuing to July 2014, and an additional payment of \$2.0 million on or before March 31, 2011. Pursuant to the *Interest* Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) (ASC Topic 835), the Company recorded the note on its balance sheet at the present value of future cash flows using an imputed interest rate. The resulting difference

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

between the par value of the note and the present value was a discount of \$1.2 million, which will be amortized to interest income using the effective interest method as payments on the note are received.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

**Marketable Securities** The Company determines the appropriate classification of investments in marketable debt and equity securities at the time of purchase and reevaluates such designation at each balance sheet date. Marketable debt and equity securities have been classified and accounted for as available for sale. The Company may or may not hold securities with stated maturities greater than 12 months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. The Company primarily invests in high-credit-quality debt instruments with an active resale market and money market funds to ensure liquidity and the ability to readily convert these investments into cash to fund current operations, or satisfy other cash requirements as needed. Accordingly, all marketable securities have been classified as current assets in the accompanying balance sheets. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity, except for unrealized losses determined to be other than temporary which would be recorded as other income or expense. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of other income or expense.

**Property and Equipment** Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of each asset, which range as follows:

Computers, diagnostic workstations and telecommunications systems	3-5 years
Office furniture and equipment	7-10 years
Software	3-7 years
Leasehold improvements	Term of lease or asset life, whichever is shorter

Expenditures for maintenance and repairs are charged to operating expense as incurred and expenditures for renewals and betterments are capitalized. Upon sale or retirement of depreciable assets, the related cost and accumulated depreciation are removed from the records and any gain or loss is reflected in operating expenses.

The cost of computer software developed for internal use is capitalized and accounted for in accordance with the *Intangibles-Goodwill and Other* Topic of FASB Accounting Standards Codification (ASC Topic 350), Subtopic 40 *Internal-Use Software*. Capitalized costs are amortized based on their expected useful lives.

Depreciation expense for the three months ended June 30, 2010 and 2009 was \$0.9 million and \$0.8 million, respectively, and \$1.9 million and \$1.6 million for the six months ended June 30, 2010 and 2009, respectively.

**Contingencies** The Company records a loss contingency for legal claims at the time the Company deems such liability to be probable. The determination of the probability of the liability is based upon a review of the claim by the Company's internal legal counsel, external legal counsel and, in the case of medical liability claims, the Company's medical liability insurance carrier. Upon the determination that a liability is probable, the Company records a loss contingency for the estimated potential claim. Actual future losses from these legal claims may differ from the Company's estimates to the extent that the Company suffers an adverse determination for a claim which the Company did not deem the liability probable, did not record a sufficient loss contingency, the loss was in excess of applicable insurance limits, or in the event that the Company does not have insurance coverage or indemnification rights covering the specific claim.

**Medical Liability Insurance** The Company is exposed to various risks of loss related to litigation that may arise related to malpractice and maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company's claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements and coverage limits. Coverage for affiliated radiologists is initiated when they begin providing services on behalf of the Company.

The Company records reserves for both asserted and IBNR amounts. Asserted claims are reserved based upon the Company's best estimate of future probable costs in accordance with the *Contingencies* Topic of the FASB Accounting Standards Codification (ASC Topic 450). The IBNR

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

reserve is intended to cover potential medical claims that might arise related to past medical services performed by the Company's affiliated radiologists which have not yet been asserted. IBNR amounts are estimated using historical claims information and actuarial-based analyses.

***Long-Lived Assets Including Goodwill and Other Acquired Intangible Assets*** Under the provisions of the *Intangibles-Goodwill and Other* Topic of the FASB Accounting Standards Codification (ASC Topic 350), certain intangible assets are amortized over their estimated useful lives. The Company currently has no goodwill on its balance sheet. Unamortized intangible assets are evaluated for impairment at least annually or more frequently if events and circumstances indicate that the goodwill and intangible assets might be impaired.

In accordance with the *Property, Plant, and Equipment* Topic of the FASB Accounting Standards Codification (ASC Topic 360), the Company periodically reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of those assets are no longer appropriate. The Company performs impairment tests using discounted cash flows, valuation analyses or comparisons to recent sales or purchase transactions to determine estimated fair value. If impairment is indicated, the asset is written down to its estimated fair value.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(unaudited)

**Concentration of Credit Risk** Financial instruments that potentially expose the Company to concentration of credit risk consist primarily of cash, cash equivalents, marketable securities and accounts receivable. The Company maintains its cash, cash equivalents and marketable securities with high-credit-quality institutions. As of June 30, 2010 and December 31, 2009, a total of \$23.4 million and \$26.2 million, respectively, of cash and cash equivalents exceeded federal government insured amounts.

**Recently Issued Accounting Standards** In January 2010, the FASB issued Accounting Standards Update (ASU) No.2010-06. This ASU amended the *Fair Value Measurements and Disclosures* Topic of the FASB Accounting Standards Codification (ASC Topic 820), to add new requirements for disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. It also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value. The ASU is effective January 1, 2010, except for the requirement to provide the separate disclosures relating to Level 3 measurements noted above. That amendment is effective January 1, 2011. The impact of adopting the portion of the ASU related to Level 1 and 2 measurements was not significant. See Note 10 Fair Value Measurements for the Company's recurring and non-recurring fair value disclosures, as required by ASC Topic 820.

**2. MARKETABLE SECURITIES**

Marketable securities include various available-for-sale securities. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity. Gross unrealized gains and losses on marketable securities were not significant at June 30, 2010 or December 31, 2009.

Below are the Company's marketable securities at fair value:

	June 30, 2010	December 31, 2009
	(In thousands)	
Due in one year or less:		
U.S. Government and federal agency securities	\$	\$ 6,000
<b>Total marketable securities</b>	<b>\$</b>	<b>\$ 6,000</b>

**3. INTANGIBLE ASSETS SUBJECT TO AMORTIZATION**

The Company amortizes its intangible assets using the straight-line method over their estimated useful lives. As required by the *Intangibles-Goodwill and Other* Topic of the FASB Accounting Standards Codification (ASC Topic 350), an interim test for impairment must be performed whenever impairment indicators are present. The Company's intangible assets included those assets acquired as part of the Company's July 2007 acquisition of MPS and ERS from SPRPA and the related agreements entered into between the Company and SPRPA. As previously disclosed the Company and SPRPA were engaged in a dispute regarding those agreements and reached a settlement on June 30, 2010.

As a result of the dispute and related settlement, the Company determined that an impairment indicator was present related to the intangible assets acquired from SPRPA. The Company concluded that \$27.3 million of the \$49.6 million carrying value of these intangible assets were impaired. As a result, the Company recorded a non-cash intangible impairment charge of \$27.3 million in the three months ended March 31, 2010. On June 30, 2010, the Company entered into a series of agreements with SPRPA, its affiliates and a third party pursuant to which the dispute was settled. As a result of the transactions, the Company and SPRPA terminated their prior agreements and the Company received consideration equal to the then remaining carrying value of the customer contract intangible asset associated with SPRPA.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

A summary of intangible assets is as follows:

	Estimated Useful Life	Historical Amount	June 30, 2010		December 31, 2009		
			Accumulated Amortization	Net Amount	Historical Amount	Accumulated Amortization	Net Amount
(In thousands)							
Customer lists and relationships	6-10 years	\$ 30,770	\$ 11,185	\$ 19,585	\$ 30,770	\$ 9,579	\$ 21,191
Tradenname and trademarks	5 years	2,540	1,838	702	2,690	1,709	981
Noncompete agreements	5 years				500	482	18
		\$ 33,310	\$ 13,023	\$ 20,287	\$ 33,960	\$ 11,770	\$ 22,190



**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Amortization expense from continuing operations was \$0.9 million and \$1.0 million for the three months ended June 30, 2010 and 2009, respectively, and \$1.9 million and \$2.1 million for the six months ended June 30, 2010 and 2009, respectively. The following is a schedule of estimated future amortization expense as of June 30, 2010:

<b>Estimated Amortization Expense (a):</b>	<b>Amount (in thousands)</b>
Six months ending December 31, 2010	\$ 1,841
Year ending December 31, 2011	3,511
Year ending December 31, 2012	2,976
Year ending December 31, 2013	2,889
Year ending December 31, 2014	2,880
Thereafter	6,190
<b>Total</b>	<b>\$ 20,287</b>

(a) Actual amortization amounts in future years may differ from amounts shown in this table due to any future acquisitions or changes in existing intangible asset balances.

**4. LONG-TERM DEBT**

The Company has outstanding a fully syndicated term loan (the Term Loan) pursuant to which the Company has \$51.8 million in outstanding borrowings as of June 30, 2010. The Term Loan is required to be repaid in quarterly installments equal to approximately \$0.1 million (such amount subject to adjustment from time to time as a result of voluntary principal payments made by the Company) with the remaining balance due in a single payment on the maturity date of July 10, 2014.

Interest under the Term Loan is based, at the option of the Company, on either: (i) a floating per annum rate based on prime rate plus 1.50% or (ii) a floating per annum rate (based upon one, two, three or six-month interest periods), which the Company has chosen, based on three-month LIBOR plus 2.50% (3.04% at June 30, 2010). The Company entered into five interest rate swap contracts during 2008 which, while in place, will maintain a fixed effective interest rate on the Term Loan of approximately 4.95%.

The credit agreement governing the Term Loan contains customary covenants and restrictions and is guaranteed by certain of the Company's wholly owned operating subsidiaries, including NightHawk Radiology Services, LLC, the Company's primary operating entity, and is collateralized by substantially all of the Company's assets.

The Term Loan is subject to mandatory repayment under certain circumstances, including in connection with the Company's receipt of proceeds from certain issuances of equity or debt, sales of assets and casualty events. In addition, the credit agreement requires a principal payment in the amount equal to 50% of the Company's Excess Cash Flow as defined in the Company's loan agreement if the Total Leverage Ratio as defined in the credit agreement is at or above 2.50 at year end. In connection with the settlement with SPRPA, the Company was required to obtain the consent of the lenders of the Term Loan and agreed to pay \$26.0 million of the Term Loan on the day of the settlement and make an additional payment of \$10.0 million on or prior to June 30, 2011. Pursuant to such consent, should the Company be required to make an Excess Cash Flow payment with respect to fiscal years 2010 and 2011, such Excess Cash Flow Payment will be reduced by an amount equal to such repayments.

The credit agreement contains customary affirmative, negative and financial covenants, including, among other requirements, negative covenants that restrict the Company's ability to create liens, enter into mergers and acquisitions, pay dividends, repurchase stock, incur

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

indebtedness, make investments and capital expenditures, and financial covenants that limit the maximum leverage the Company can maintain at any one time. The maximum Total Leverage Ratio allowed under the terms of the loan is below 4.00 as measured on a trailing four quarter basis. The Total Leverage Ratio excludes non-cash charges such as goodwill and intangible impairment charges and stock compensation. In addition, pursuant to the terms of the Company's credit agreement, the Company is required to calculate its Total Leverage Ratio on a pro forma basis, meaning that the Company must calculate its Total Leverage Ratio assuming the SPRPA settlement transaction took place at the beginning of the trailing four quarter measurement period. As of June 30, 2010, the Company's Total Leverage Ratio was 3.08. As of June 30, 2010, the Company was in compliance with all covenants contained in the credit agreement.

The Term Loan may be voluntarily repaid without premium or penalty. The Company made required principal payments of \$0.4 million on the Term Loan during the six months ended June 30, 2010 and as described above, the Company made a principal payment of \$26 million immediately following the closing of transaction on June 30, 2010 and will make an additional principal payment of \$10 million on or before June 30, 2011 in connection with the settlement between the Company and SPRPA. For more information on the effects of such settlement, see also Note 3 Intangible Assets Subject to Amortization.

**Table of Contents**

**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(unaudited)

As of June 30, 2010, the fair value of long-term debt, including the current portion, is estimated to be approximately \$46.6 million.

**5. COMMITMENTS AND CONTINGENCIES**

**Litigation** The Company is involved in litigation in the normal course of business. After consultation with legal counsel, Company management estimates that at June 30, 2010 these matters were expected to be resolved without material adverse effect on the Company's financial position, results of operations, or cash flows.

On December 17, 2009, a putative shareholder class action lawsuit was filed against the Company and certain of the Company's former officers in the U.S. District Court for the District of Idaho. The case is captioned *City of Marysville General Employees Retirement System v. NightHawk Radiology Holdings, Inc., et al.*, Case No. CIV 09-659-N-CWD. On July 13, 2010, plaintiffs filed an amended complaint under the new caption *In re Nighthawk Radiology Holdings, Inc. Securities Litigation*, Master File No. 09-cv-00659 (EJL/CWD). The complaint purports to be brought on behalf of a class of persons who purchased or otherwise acquired the Company's stock during the period May 2, 2007 to May 7, 2008, and asserts claims under Section 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. Plaintiffs contend that the Company and the individual defendants violated the federal securities laws by issuing false and misleading statements concerning the Company's operations, business, and prospects during the purported class period, and thereby artificially increased the price of the Company's stock. Plaintiffs seek unspecified compensatory damages, interest, and attorneys' fees and costs. On April 29, 2010, the court issued an order appointing Plymouth County Contributory Retirement System (Plymouth) as lead plaintiff, and approving Plymouth's selection of the law firms Scott + Scott LLP and Holland & Hart LLP as co-lead counsel. Pursuant to a stipulated case management order, defendants have until September 13, 2010 to move to dismiss the complaint. Management intends to vigorously defend against these claims.

**Medical Liability** In addition to the litigation matters described above, the Company is also exposed to various risks of loss related to litigation that may arise related to medical malpractice claims. The Company maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company's claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services on behalf of the Company.

The Company records reserves for both asserted legal claims (medical liability and otherwise) as well as IBNR amounts for incurred but not reported medical liability claims. Asserted claims are reserved based upon the Company's best estimate of future probable loss in accordance with the *Contingencies* Topic of the FASB Accounting Standards Codification (ASC Topic 450). The IBNR reserve is intended to cover potential medical claims that might arise related to past medical services performed by the Company's affiliated radiologists which have not yet been asserted. IBNR amounts are estimated using historical claims information and actuarial-based industry indices. During the six months ended June 30, 2010 and 2009, the Company recorded a credit adjustment of \$0.9 million and an expense \$0.4 million, respectively, for estimated IBNR amounts. IBNR amounts, recorded as insurance reserve on the balance sheet at June 30, 2010 and December 31, 2009 totaled \$3.1 million and \$4.0 million, respectively.

**6. STOCK COMPENSATION PLANS**

**Stock-Based Award Plans** The Company has two stock-based award plans, the 2004 Stock Plan (the 2004 Plan) and the 2006 Equity Incentive Plan (the 2006 Plan). In February 2006, all shares available for grant under the 2004 Plan were rolled over and became available for grant under the 2006 Plan. In addition, on the first day of each fiscal year beginning in 2007, the number of shares available for issuance under the 2006 Plan may be increased by an amount equal to the lesser of (i) 3% of the outstanding shares of the Company's common stock on the first day of the fiscal year and (ii) such other amount as the Company's Board of Directors may determine. As of June 30, 2010, the Company had an aggregate of 5,529,813 shares of its common stock reserved for issuance under the 2004 Plan and 2006 Plan. Of these shares, 1,050,087 shares were available for future grants and 4,479,726 shares were subject to outstanding stock awards as of June 30, 2010.

The Company's Board of Directors administers the plans, establishes to whom the awards are granted, and sets the terms and conditions, including the exercise period, of such awards. All stock options granted have an exercise price equal to or greater than the fair value of the

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Company's common stock on the date the option is granted. All restricted stock units ( RSUs ) are granted with an exercise price of zero. Both stock options and RSUs granted generally have contractual terms of ten years and vest over two, three, or four years, depending upon the type of grant. Options and RSUs granted to employees and directors are valued using the Black-Scholes model, and the resulting expense is recognized using the accelerated method over the service period for the entire award.

**Non-Employee Grants** The Company records physician stock-based compensation expense in connection with any equity-based grants to the Company's affiliated radiologists in accordance with the *Compensation-Stock Compensation* Topic of the FASB Accounting Standards Codification (ASC Topic 718) and the *Equity* Topic of the FASB Accounting Standards Codification (ASC Topic 505).

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Because the Company's affiliated radiologists are independent contractors, the Company calculates the fair value of the stock-based compensation expense in each period. The amount of physician stock-based compensation expense the Company records in a given period depends primarily on the number of shares subject to equity-based grants held by the Company's affiliated radiologists, the number of hours worked, and the value of the Company's common stock at the end of the period. If the price of the Company's common stock increases over a given period, this accounting treatment results in compensation expense that exceeds the expense the Company would have recorded if these individuals were employees. Stock-based compensation to the Company's affiliated radiologists is included in professional services expense.

**Stock-Based Awards Summary** A summary of the Company's stock-based award activity for employees and non-employees under the 2004 and 2006 plans is as follows:

	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
<b>Stock Options</b>				
Outstanding as of April 1, 2010	3,052,344	\$ 5.50		
Granted	10,000	3.19		
Exercised	(17,428)	2.80		
Cancelled	(302,462)	6.34		
Outstanding as of June 30, 2010	2,742,454	\$ 5.42	7.23	\$ 352
Exercisable as of June 30, 2010	1,765,672	\$ 6.03	6.45	\$ 352
	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Outstanding as of January 1, 2010	3,170,333	\$ 5.51		
Granted	12,000	3.16		
Exercised	(21,512)	2.57		
Cancelled	(418,367)	6.23		
Outstanding as of June 30, 2010	2,742,454	\$ 5.42	7.23	\$ 352
Exercisable as of June 30, 2010	1,765,672	\$ 6.03	6.45	\$ 352
Vested and expected to vest as of June 30, 2010	2,695,715	\$ 5.44	7.21	\$ 352

The weighted-average grant-date fair values per share for options granted during the three and six months ended June 30, 2010 was \$1.61.

Activity related to the Company's restricted stock unit awards is as follows:

Restricted Stock Unit Awards	Number of Awards	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Outstanding as of April 1, 2010	1,846,615
Granted	166,740
Vested (a)	(143,938)
Cancelled	(132,145)

Outstanding as of June 30, 2010	1,737,272	1.51	\$ 4,500
---------------------------------	-----------	------	----------

	Number of Awards	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Outstanding as of January 1, 2010	961,230		
Granted	1,112,240		
Vested (a)	(171,215)		
Cancelled	(164,983)		

Outstanding as of June 30, 2010	1,737,272	1.51	\$ 4,500
---------------------------------	-----------	------	----------

Vested and expected to vest as of June, 2010	1,618,849	1.45	\$ 4,193
--	-----------	------	----------

(a) The number of RSU awards vested includes shares withheld on behalf of employees to satisfy the statutory tax withholding requirements.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Intrinsic value represents the amount by which the fair market value of the underlying stock exceeds the exercise price of the options and RSUs. Fair market value is the Company's closing stock price as of June 30, 2010, which was \$2.59.

**Recognition of Compensation Expense** During the three months ended June 30, 2010 and 2009, the Company recognized stock compensation of \$0.7 million and \$1.5 million, respectively, and \$1.2 million and \$2.6 million during the six months ended June 30, 2010 and 2009, respectively. As of June 30, 2010, the total remaining unrecognized compensation cost related to unvested stock-based employee/director arrangements, net of an estimated forfeiture rate of 8.9%, was \$3.8 million and is expected to be recognized over a weighted average period of 1.48 years.

The Company measures the compensation cost associated with stock-based payments by estimating the fair value of stock options as of the grant date using the Black-Scholes option pricing model. The Company believes this valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the stock options granted. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The assumptions used to estimate the fair value of the stock-based arrangements were as follows:

	<b>Three Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Dividend yield		
Expected volatility	64%	56%
Risk-free interest rates	1.68%	1.72%
Expected term for employees (years)	4.3	3.9
Expected term for non-employee (years)	N/A	10

  

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Dividend yield		
Expected volatility	64%	56%
Risk-free interest rates	1.70%	1.77%
Expected term for employees (years)	4.3	4.2
Expected term for non-employee (years)	N/A	10

Expected volatility is estimated by looking at the historical volatility of the Company's stock price and considering whether or not the Company's future stock prices are expected to be materially different than the past. The risk-free interest rate is based on the U.S. Treasury yields in effect at the time of grant corresponding with the expected term of the options. The expected option term for employees is the number of years estimated that options will be outstanding prior to exercise considering vesting schedules, historical exercise experience and other relevant factors.

**7. EARNINGS PER SHARE**

The following table presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per common share computations (dollars in thousands, except share data):

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
(In thousands, except share data)				
<b>Numerator:</b>				
Net income (loss) from continuing operations	\$ (2,566)	\$ 1,662	\$ (5,016)	\$ (47,022)
Net income (loss) from discontinued operations	(1,619)	432	(18,364)	(3,497)
Net income (loss) available to common shareholders	\$ (4,185)	\$ 2,094	\$ (23,380)	\$ (50,519)
<b>Denominator:</b>				
Weighted average common shares outstanding basic	23,671,256	26,490,880	23,624,158	26,569,576
Effect of dilutive stock options, RSUs, and warrants (a)		467,813		
Weighted average common shares outstanding dilutive	23,671,256	26,958,693	23,624,158	26,569,576
Anti-dilutive shares excluded from calculation	3,515,345	2,993,156	3,040,558	3,635,310

- (a) The effects of the shares which would be issued upon exercise of these options, RSUs and warrants have been excluded from the calculation of diluted earnings (loss) per common share for the three months ended June 30, 2010, and the six months ended June 30, 2010 and June 30, 2009 because they are anti-dilutive.



**Table of Contents**

**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

**8. INCOME TAXES**

The effective tax rates on income from continuing operations for the three months ended June 30, 2010 and 2009 were (34.9%) and 39.1%, respectively. The difference in effective rates was primarily attributable to the write-off of unrealized deferred tax assets related to stock compensation in the three months ended June 30, 2010. The effective tax rates on income from continuing operations for the six months ended June 30, 2010 and 2009 were (0.5%) and 17.8%, respectively. The difference in effective rates was primarily attributable to the Company recording a non-cash goodwill impairment charge in the quarter ended March 31, 2009, a portion of which was not deductible for tax purposes.

Based on the Company's current assessment of future taxable income, including available tax planning opportunities, the Company anticipates that it is more likely than not that it will generate sufficient taxable income to realize its deferred tax assets, and therefore the Company did not record a valuation allowance against its deferred tax assets as of June 30, 2010, except for a valuation allowance of \$1.4 million (\$0.9 million net of federal tax benefit) on a state net operating loss due to the limited number of remaining years to carry the loss forward in that state. However, changes in the estimate of future taxable income and deterioration in the business and economic climate could significantly affect the determination of the necessity for a valuation allowance against deferred tax assets in future periods.

**9. DERIVATIVE FINANCIAL INSTRUMENTS**

The Company recognizes all derivatives on the condensed consolidated balance sheet at fair value. The Company designates at inception whether the derivative contract is considered hedging or non-hedging in accordance with the *Derivatives and Hedging* Topic of the FASB Accounting Standards Codification (ASC Topic 815).

In December 2008, the Company settled the two interest rate swap contracts entered into during 2007 resulting in a cash payment by the Company of \$5.3 million. The pre-tax net unrealized loss within accumulated other comprehensive income associated with the cancelled interest rate swap contracts of \$5.3 million is being amortized to interest expense over the original lives of the contracts. Of this \$5.3 million amount, \$3.3 million was recognized in 2009 and \$1.3 million was recognized during the six months ended June 30, 2010, leaving \$0.7 million to be amortized to interest expense over the next three months. The cancelled swap contracts were replaced with five interest rate swap contracts with a combined notional amount of \$93.5 million. All contracts expire on June 30, 2014 and, while in effect, maintain an effective interest rate on the Company's outstanding debt of approximately 4.95%.

The contracts were initiated to maintain compliance with debt requirements and to protect the Company against changes in the interest payments associated with its variable-rate long-term debt, and therefore are considered cash flow hedges. As a result, as long as the swap contract is deemed highly effective, changes in the fair value of the swap contract are recorded as either an asset (a gain position) or a liability (a loss position) on the balance sheet, with the offset recorded in accumulated other comprehensive income, a separate component of stockholders equity. At June 30, 2010 and December 31, 2009, the fair value of the interest rate swap contracts on the Company's balance sheets was a liability (a loss position) of \$2.8 million and an asset (a gain position) of \$1.1 million, respectively.

As a condition to the consent the Company obtained from its lenders in connection with the settlement with SPRPA the Company agreed to pay \$26.0 million of its Term Loan on June 30, 2010 and an additional \$10.0 million no later than June 30, 2011. As a result of the repayments, the Company determined that the three remaining effective interest rate swap contracts no longer met the criteria for treatment as cash flow hedges under the guidance of ASC Topic 815 and related interpretations. Consequently, the Company prospectively discontinued cash flow hedge accounting for these interest rate swap contracts effective January 1, 2010. Because cash flow hedge accounting will not be applied to any interest rate swap contracts, changes in the fair value of these interest rate swap contracts subsequent to January 1, 2010 have been recorded as a component of interest expense in the Company's statement of operations and will be on a prospective basis. For the three and six months ended June 30, 2010, the interest expense associated with these ineffective hedges was \$2.5 million and \$4.0 million, respectively.

---

**Table of Contents**

**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

In addition, the Company was also required to begin amortizing the related \$0.9 million of pre-tax net unrealized gain within accumulated other comprehensive income to as a credit to interest expense over the remaining lives of the interest rate swap contracts, which is June 30, 2014. Of this \$0.9 million amount, \$0.4 million was recognized as a credit to interest expense during the six months ended June 30, 2010, leaving \$0.5 million to be amortized in future periods.

**10. FAIR VALUE MEASUREMENTS**

The *Fair Value Measurements and Disclosures* Topic of the FASB Accounting Standards Codification (ASC Topic 820), defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

*Level 1* Quoted prices in active markets for identical assets or liabilities.

*Level 2* Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3* Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company uses quoted market prices for identical assets to measure the fair value of its investments in money market funds and marketable securities and therefore considers all of the Company's money market funds and marketable securities as Level 1.

The Company has determined that its interest rate swaps are Level 2 in the fair value hierarchy discussed above. As discussed in Note 4 Long-Term Debt, the Company's interest rate swaps are based on a LIBOR rate. Fair value for the interest rate swaps are based on a model-derived valuation using the LIBOR rate, which is observable at commonly quoted intervals for the full term of the swap.

The fair values of the Company's money market funds using Level 1 inputs on a recurring basis as of June 30, 2010 and December 31, 2009 were \$12.4 million and \$18.9 million, respectively. The carrying value of the Company's note receivable of \$12.8 million as of June 30, 2010 approximates its fair value. The fair value of the Company's marketable securities using Level 1 inputs on a recurring basis as of December 31, 2009 was \$6.0 million. The fair values of the Company's interest rate swap contracts using Level 2 inputs on a recurring basis as of June 30, 2010 and December 31, 2009 were a loss position of \$2.8 million and a gain position of \$1.1 million, respectively.

**11. RESTRUCTURING CHARGE**

During the quarter ended June 30, 2010, the Company recorded a pre-tax charge of \$1.1 million in accordance with the *Exit or Disposal Cost Obligations* Topic of the FASB Accounting Standards Codification (ASC Topic 420). The charge was comprised of (i) \$0.6 million pertaining to vacated leased facilities located in San Francisco, California, Austin, Texas and a portion of the Company's office facility in Coeur d'Alene, Idaho, (ii) \$0.3 million in employee severance costs and (iii) fixed asset impairment charges of \$0.2 million for certain property, plant and equipment within the vacated leased facilities that no longer have value to the Company.

The accrual related to vacated facilities is calculated net of any estimated sublease income which is estimated based on current market quotes for similar properties and the anticipated timing of any potential subleases. If the Company is unable to sublet the vacated properties on a timely basis or is forced to sublet them at lower rates due to changes in market conditions, the Company will adjust the accruals accordingly. The charge was recognized in sales, general, and administrative expense. During the three and six months ended June 30, 2010, the Company made no cash payments or non-cash adjustments to the accrual. The reserve amount on the Company's balance sheet for these and other vacated leased

facilities as of June 30, 2010 totaled \$0.9 million.

**Table of Contents****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****12. DISCONTINUED OPERATIONS**

The Company determined that the business services operations of MPS and the teleradiology operations of ERS became discontinued operations during the quarter ended June 30, 2010. The Company therefore recorded the operations of MPS and ERS as discontinued operations in accordance with the *Presentation of Financial Statements* Topic of the FASB Accounting Standards Codification (ASC Topic 205). As a result, the Company has segregated the assets and liabilities and operating results of MPS and ERS from continuing operations on the Company's balance sheet and in the consolidated statements of operations for all periods prior to the settlement transaction.

The following table summarizes results of discontinued operations for the periods indicated (dollars in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Service revenue	\$ 5,269	\$ 5,580	\$ 10,212	\$ 10,797
Expenses:				
Professional services	931	912	1,736	1,700
Sales, general and administrative	2,439	2,773	5,072	5,494
Depreciation and amortization	2,217	882	3,141	1,764
Goodwill and intangible asset impairment			27,326	6,933
Interest expense	1,337	295	1,577	598
Total expenses	6,924	4,862	38,852	16,489
Income (loss) from discontinued operations	(1,655)	718	(28,640)	(5,692)
Income tax expense (benefit)	(36)	286	(10,276)	(2,195)
Net income (loss) from discontinued operations	\$ (1,619)	\$ 432	\$ (18,364)	\$ (3,497)

The following assets and liabilities have been segregated and classified as assets and liabilities of discontinued operations in the consolidated balance sheets as of June 30, 2010 and December 31, 2009 (dollars in thousands):

	<b>June 30,</b>	<b>December 31,</b>
	<b>2010</b>	<b>2009</b>
<b>ASSETS</b>		
Trade accounts receivable, net	\$ 1,492	\$ 3,891
Prepaid expenses and other current assets		453
Total current assets of discontinued operations	1,492	4,344
Property and equipment, net		2,482
Intangible assets, net		50,360
Deferred income taxes		1,299
Total long-term assets of discontinued operations		54,141

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Total assets of discontinued operations	\$ 1,492	\$ 58,485
<b>LIABILITIES</b>		
Accrued expenses and other liabilities	\$	\$ 313
Accrued payroll and related benefits	266	309
Total liabilities of discontinued operations	\$ 266	\$ 622

---

## **Table of Contents**

### **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This quarterly report contains forward-looking statements that involve risks and uncertainties. The statements contained in this quarterly report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In some cases you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, project, predict, and potential, and similar expressions intended to identify forward-looking statements. These forward-looking statements include, without limitation, statements relating to future economic conditions in general and statements about our future:*

*strategy and business prospects;*

*development and expansion of services, and the size, growth, and leadership of the potential markets for these services;*

*development of new customer relationships and products;*

*sales, earnings, income, expenses, operating results, tax rates, operating and gross profit and profit margins, valuations, receivables, reserves, liquidity, investment income, currency rates, employee stock option exercises, capital resource needs, customers, and competition;*

*ability to obtain and protect our intellectual property and proprietary rights; and*

*acquisitions and transaction costs and adjustments.*

*All of these forward-looking statements are based on information available to us on the date of this quarterly report. Our actual results could differ materially from those discussed in this quarterly report. The forward-looking statements contained in this quarterly report, and other written and oral forward-looking statements made by us from time to time, are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in Part II Item 1A of this report entitled "Risk Factors" .*

### **Overview**

We are leading the transformation of the practice of radiology by providing high-quality, cost-effective solutions to radiology groups and hospitals throughout the United States. Our team of independent contractor, American Board of Radiology-certified, state-licensed and hospital-privileged physicians, provides professional services ( interpretations , exams , scans or reads ) 24 hours per day, seven days a week, for approximately 26% of all U.S. hospitals. The reads that we provide continue to consist primarily of off-hours preliminary reads, but increasingly include final and sub-specialty interpretations. For more information, visit our website at [www.nighthawkrad.net](http://www.nighthawkrad.net). The information contained on, or accessible through, our website is not incorporated in this filing.

### **Recent Developments**

#### *Resolution of Dispute with St. Paul Radiology, P.A. and Related Transaction*

As previously disclosed in our Quarterly Report on Form 10-Q for the period ended March 31, 2010 filed with the Securities and Exchange Commission on May 7, 2010, we and St. Paul Radiology, P.A. (or SPRPA) have been involved in a dispute regarding certain agreements entered into between us and SPRPA in 2007. On June 30, 2010, such dispute was settled pursuant to the agreements described in further detail below.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

*Purchase Agreement.* We entered into an agreement with FutureRad, LLC, a privately-held company, pursuant to which we sold all of the outstanding membership interests of our wholly-owned subsidiaries, Midwest Physicians Services, LLC (or MPS) and Emergency Radiology Services, LLC (or ERS), for \$2.0 million in cash.

*Termination Agreement.* In connection with the settlement, we also entered into a termination agreement with SPRPA and its affiliate Midwest Radiology, LLC, MWR, pursuant to which certain agreements between the parties, including administrative support services agreements, a professional services agreement and a data license agreement were terminated. In addition, SPRPA surrendered for cancellation a warrant to purchase 300,000 shares of our common stock that it received in connection with the original transaction in 2007.

Pursuant to the terms of such agreement, SPRPA and MWR agreed to pay an aggregate of \$24.0 million, consisting of (i) an upfront cash payment to us of \$10.0 million (which amount includes a payment of \$2.5 million due to us and our affiliates for services previously rendered pursuant to the support services agreements being terminated) and (ii) 48 equal monthly payments of \$250,000 beginning August 16, 2010 and an aggregate of \$2.0 million on or prior to March 31, 2011 in one or more installments pursuant to the terms of a promissory note issued by SPRPA to us.

*Principal Payment of our Term Loan.* In connection with the settlement with SPRPA, we were required to obtain the consent of the lenders under our credit agreement and agreed to pay an aggregate of \$26.0 million in term loan borrowings on the date of the settlement (which we made using the upfront cash payment from SPRPA and cash on hand) and to make an additional payment of \$10.0 million on or prior to June 30, 2011.

*Acceleration of Unamortized Deferred Loan Fees.* As a result of the \$26.0 million payment of term loan borrowings under our credit agreement, we determined that an adjustment to the unamortized deferred loan fees associated with the original incurrences of such indebtedness was required. An amount equal to \$1.0 million was written off in the three months ended June 30, 2010 and the remaining balance will be amortized using the effective interest method over the life of such indebtedness.

---

## **Table of Contents**

*Impact on Financial Results from SPRPA settlement agreement.* As a result of the settlement with SPRPA, our financial results will be impacted. In the first six months of 2010, we generated an aggregate of \$10.2 million, or approximately 14% of our total revenue, from our original agreements with SPRPA. As a result of the settlement, beginning July 1, 2010, we no longer derive revenue from such agreement and related profits that we have historically generated from our relationship with SPRPA. As a result, our Total Leverage Ratio under our credit agreement will likely increase. See *Liquidity and Capital Resources* *Financial Condition and Liquidity*. See also *Part II Item 1A Risk Factors* *We may need additional capital, which may not be available to us.*

### *Cost Reduction Actions and Related Restructuring Charges*

As part of a plan to reduce our operating costs, we have closed offices in San Francisco, California, Austin, Texas and a portion of our office facility in Coeur d'Alene, Idaho. As a result of these closures and a related reduction in force of approximately 35 employees, we incurred restructuring costs of \$1.1 million, consisting of \$0.6 million in lease disposal charges, \$0.2 million in asset write-off charges and \$0.3 million in employee severance costs. These charges are included in our results of operations for the three and six months ended June 30, 2010. We estimate that these actions will result in a reduction in our annual operating expenses of approximately \$4 million.

### *Trends in our Business and Results of Operations*

#### *Evolving Marketplace.*

The market for our services continues to evolve rapidly, as we continue to see significant competition in the market for our services, resulting in continued price declines and increased customer attrition. More recently, we are also experiencing slower growth in volumes at existing customers. We believe this trend results primarily from lower utilization of healthcare services in general resulting in fewer imaging scans and from some of our customers reading later into the night in order to maintain their own volumes. In response, we have focused our efforts on setting and maintaining high quality service levels, demonstrating the value of our services to our customers and their patients, and when appropriate, lowering our prices to retain customers or gain new customers.

#### *Service Revenue.*

We generate revenue primarily from off-hours preliminary exams and to a lesser extent from final and subspecialty interpretations. As described above, over the course of the last several quarters, we have continued to experience a maturing and highly competitive marketplace and a slowing in organic growth, resulting in slow or no growth in scan volumes. In addition, we have also seen the average price for our services decline significantly and experienced customer losses. All of these factors have caused our revenues and margins to decline in recent periods. We expect these challenges to continue in the foreseeable future. In response to such trends, our strategy is to sell new services, principally final interpretations, to our existing customers and to new customers by communicating their value and demonstrating the advantages we offer over our competitors. For example, in the last 12 months, our finals business has increased from approximately 13% of our revenue to approximately 16% for the quarter ended June 30, 2010. We anticipate that our finals business will continue to become a larger percentage of our overall business in future periods.

#### *Professional Service Expenses.*

Professional service expenses consist primarily of the fees we pay to our affiliated radiologists, any physician stock-based compensation, the premiums for medical liability insurance, and any medical liability claims loss expenses. Since inception, our professional service fees have increased in absolute dollars each year, primarily due to the increased number of reads performed as our volumes have increased and the addition of new affiliated radiologists to perform the increased workload. We expect that our professional service fees will continue to fluctuate in absolute dollars as volumes and modality mix vary. We also expect our professional services expenses to increase as a percentage of revenue due to the shift in our business towards more final reads and due to the price declines we are experiencing. In response to these trends, we are identifying ways to lower our professional services expense. In addition, we are also seeking to contract with affiliated physicians at more competitive rates.

Our medical liability expense continues to fluctuate in absolute dollars each year, primarily due to changes in volumes and claims experience. We expect our medical liability premiums and our reserves for incurred but not reported (IBNR), medical liability claims to continue to fluctuate as our claims experience and volumes change over time.

We record physician stock-based compensation expense in connection with any equity-based grants to our affiliated radiologists in accordance with the *Compensation-Stock Compensation* Topic of the FASB Accounting Standards Codification (ASC Topic 718) and the *Equity* Topic of the FASB Accounting Standards Codification (ASC Topic 505), and present this expense in our consolidated statements of operations as part of our professional services expense. The amount of physician stock-based compensation expense we record in a given period depends primarily on



## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

the number of shares subject to equity-based grants held by our affiliated radiologists, the number of hours worked, and the change in the value of our common stock in that period. Our expense in future periods for physician stock-based compensation will be driven primarily by changes in our stock price, new equity-based grants we make to our affiliated radiologists, and the rate at which those equity-based grants are earned over such periods. We anticipate increased physician stock-based compensation expense this year and in 2011 resulting primarily from equity grants of our common stock issued during the quarter ended March 31, 2010 to our affiliated physicians in connection with the adoption of a new form of physician contract in December 2009.

## **Table of Contents**

### *Sales, General and Administrative Expenses.*

Our sales, general and administrative expenses consist primarily of salaries and related expenses for our employees, employee stock-based compensation, information technology and telecommunications expenses, costs associated with licensing and privileging our affiliated radiologists, facilities and office-related expenses, sales and marketing expenses and other general and administrative expenses. Our sales, general and administrative expenses have increased in absolute dollars since inception primarily as a result of increased payroll expenses in connection with higher headcount in support of the growth in our business. Recently we have undertaken cost reduction initiatives which included headcount reductions and facilities closures. We are continuing to evaluate opportunities to reduce costs and drive efficiencies throughout our organization by optimizing and automating our workflow processes.

### *Interest Expense.*

Interest on our outstanding debt is at a variable rate. Since 2007, we have hedged the risk associated with fluctuations in interest rates by entering into interest rate swap contracts. In December 2008, we settled our original interest rate swap contracts and entered into five new interest rate swap contracts that have a term roughly equal to the remaining term on our loan. The effective interest rate and actual cash payments for interest under these hedges will be approximately 4.95% for the remaining life of the loan. The interest rate swap contracts expire in June 2014. Until the maturity of our term loan, reported interest expense will differ from our effective rate due to the mark-to-market adjustments on our ineffective interest rate swap contracts, the effect of cancelled and ineffective interest rate swap contracts, and loan fee amortization. Effective January 1, 2010, we have deemed all of our interest rate swap contracts to be ineffective hedges, and therefore all of the mark-to-market adjustments related to our interest rate swap contracts impact interest expense, leading to significant fluctuations in interest expense. Finally, interest expense may be lower in future periods due to recent and future principal repayments.

### *Income Tax Expense.*

Income tax expense consists of U.S federal, state, and foreign jurisdiction income taxes. We expect our income tax expense to fluctuate due to changes to the Internal Revenue Code and the apportionment of our business geographically with regards to state taxes. Our income tax expense may also increase or fluctuate in future periods if our actual stock compensation deductions are less than our previously recognized tax benefit in accordance with the *Compensation-Stock Compensation* Topic of the FASB Accounting Standards Codification (ASC Topic 718).

### ***Critical Accounting Estimates and Recently Issued Accounting Standards***

The preparation of financial statements in accordance with GAAP requires our management to select and apply accounting policies that best provide the framework to report the results of operations and financial position. The selection and application of those policies requires management to make difficult, subjective and/or complex judgments concerning reported amounts of revenue and expenses during the reporting period and the reported amounts of assets and liabilities at the date of the financial statements. As a result, there exists the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

As of June 30, 2010, there have been no significant changes with regard to the critical accounting policies disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009. The policies disclosed included contingencies, accounting for long-lived assets, stock-based compensation, income taxes and derivative accounting.

See Note 1 Summary of Significant Accounting Policies Recently Issued Accounting Standards to the condensed consolidated financial statements included in Item 1 of this report for additional information regarding recently adopted and new accounting pronouncements.

**Table of Contents****Results of Operations**

The discussion of our results of continuing operations below relates exclusively to our preliminary, final and sub-specialty interpretations business. It excludes the results related to the business services operations of MPS and the teleradiology operations of ERS prior to the settlement with SPRPA on June 30, 2010. The results of operations for the business services operations of MPS and teleradiology operations of ERS have been segregated from continuing operations and reflected as discontinued operations for all periods presented. See Note 12 Discontinued Operations to the accompanying consolidated statements. Our results of continuing operations were as follows:

The following table sets forth selected consolidated statements of operations data for each of the periods indicated as a percentage of service revenue:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Service revenue	100%	100%	100%	100%
Operating costs and expenses:				
Professional services	49	47	51	47
Sales, general and administrative	40	36	41	36
Depreciation and amortization	6	5	6	5
Goodwill and intangible asset impairment				88
<b>Total operating costs and expenses</b>	<b>95</b>	<b>88</b>	<b>98</b>	<b>176</b>
Operating income (loss)	5	12	2	(76)
Other income (expense):				
Interest expense	(11)	(4)	(10)	(5)
Interest income				
Other, net				
<b>Total other income (expense)</b>	<b>(11)</b>	<b>(4)</b>	<b>(10)</b>	<b>(5)</b>
Income (loss) from continuing operations before income taxes	(6)	8	(8)	(81)
Income tax expense (benefit)	2	3		(14)
<b>Net income (loss) from continuing operations</b>	<b>(8)</b>	<b>5</b>	<b>(8)</b>	<b>(67)</b>

**Comparison of Three Months Ended June 30, 2010 and June 30, 2009****Service Revenue**

	Three Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Service revenue	\$ 33,560	\$ 36,760	\$ (3,200)	(9)%

The decrease in service revenue for the three months ended June 30, 2010 million compared to prior year period. was primarily driven by declines in our average price. Preliminary read revenue declined \$3.5 million while final read revenue increased by \$0.5 million.

The preliminary read revenue decrease was primarily driven by an 8% decline in our average price from the same period in 2009. Preliminary read volume declined by 3% from the same period in 2009, the result of same site volume growth of 2% and new customer volumes of 6%, offset by a 10% decrease in volumes from the cumulative impact of customers lost over the past 12 months.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

The final read revenue increase was primarily driven by a 37% increase in volume partially offset by a 20% decline in the average price compared to the same period a year ago. Final read volume growth consisted of new customer growth of 63% offset by same site volume decline of 8% and a 19% decrease in volume from the impact of customers lost over the past 12 months. The 20% decline in final read pricing was predominately driven by a mix shift towards lower-priced plain film reads and competitive pressures in the marketplace.

**Table of Contents***Operating Costs and Expenses**Professional Services*

	Three Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Professional services	\$ 16,327	\$ 17,393	\$ (1,066)	(6)%
Percentage of service revenue	49%	47%		

The decrease in professional services expense for three months ended June 30, 2010 compared to the prior year period was primarily attributable to a reduction to reserves for IBNR medical liability claims of \$0.9 million resulting from updates to our historical claims data and the reversal of a \$0.4 million reserve relating to Australian-based physicians workers compensation liabilities no longer deemed probable. The increase in professional services expense as a percentage of revenue resulted from the declines in our average price per scan from the year-ago quarter.

*Sales, General and Administrative Expense*

	Three Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Sales, general and administrative expense	\$ 13,538	\$ 13,211	\$ 327	2%
Percentage of service revenue	40%	36%		

The increase in sales, general and administrative expense for the three months ended June 30, 2010 was primarily attributable to the \$1.1 million restructuring charge described above. In addition, we saw higher legal costs related to the legal matters described in Part II Item 1 Legal Proceedings. These increases were partially offset by lower stock compensation and licensing and privileging costs.

*Interest Expense*

	Three Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Interest expense	\$ 3,744	\$ 1,630	\$ 2,114	130%
Percentage of service revenue	11%	4%		

The increase in interest expense for the three months ended June 30, 2010 compared to the prior year period was primarily attributable to the discontinuation of hedge accounting for all five of our interest rate swap contracts effective January 1, 2010 as compared to one ineffective hedge as of June 30, 2009. As a result, the year-to-date non-cash change in the fair value of the ineffective hedges of \$2.5 million was recorded to interest expense compared to \$0.2 million as of June 30, 2009.

*Income Tax Expense (Benefit)*

	Three Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Income tax expense	\$ 664	\$ 1,065	\$ (401)	(38)%
Effective tax rate	(34.9%)	39.1%		

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

The decrease in income tax expense for the three months ended June 30, 2010 compared to the prior year period was primarily due to changes in pre-tax income, partially offset by the write-off of deferred tax assets related to stock compensation expense of \$2.1 million.

The difference in effective tax rates was primarily attributable to the write-off of unrealized deferred tax assets related to stock compensation in the three months ended June 30, 2010.

**Table of Contents****Income (Loss) from Discontinued Operations, Net of Tax**

	Three Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Income (loss) from discontinued operations, net of tax	\$ (1,619)	\$ 432	\$ (2,051)	(475)%

The results of the MPS business services operations and the teleradiology operations of ERS disposed of on June 30, 2010 are included in income (loss) from discontinued operations, net of tax, for all periods presented. For the three months ended June 30, 2010, the discontinued operations generated a net loss of \$1.6 million on \$5.3 million in revenue, as compared to net income of \$0.4 million for the three months ended June 30, 2009 on \$5.6 million in revenue. The decline from the year-ago quarter is primarily due to higher amortization of intangible assets and increased interest expense due to the acceleration of deferred loan fees arising from the repayment of debt upon the settlement with SPRPA.

**Comparison of Six Months Ended June 30, 2010 and June 30, 2009****Service Revenue**

	Six Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Service revenue	\$ 65,165	\$ 70,342	\$ (5,177)	(7)%

The decrease in service revenue for the six months ended June 30, 2010 compared to the prior year period was driven primarily by a \$6.1 million decline in preliminary read revenue, partially offset by an increase of \$1.0 million in final read revenue.

The preliminary read revenue decrease was primarily driven by a 9% decline in our average price from the same period in 2009. Preliminary read volumes declined 1% from the same period in 2009, consisting of same site volume growth of 2% and new customer volume growth of 6%, partially offset by a 10% decrease in volume from the cumulative impact of customers lost over the past 12 months.

The final read revenue increase was primarily driven by a 43% increase in volume partially offset by a 22% decline in the average price compared to the same period a year ago. Final read volume growth consisted of new customer growth of 76% offset by 13% declines in same site volume and a 20% decrease from the impact of customers lost over the past 12 months. The 22% decline in final read pricing was predominately driven by a mix shift towards lower priced plain film reads and competitive pressures in the marketplace.

**Operating Costs and Expenses****Professional Services**

	Six Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Professional services	\$ 32,986	\$ 33,261	\$ (275)	(1)%
Percentage of service revenue	51%	47%		

The decrease in professional services expense for the six months ended June 30, 2010 compared to the prior year period was primarily attributable to lower medical malpractice liability reserves and a shift in mix towards lower cost plain films. The increase in professional services expense as a percentage of revenue resulted from the decline in our average price per scan.





**Table of Contents****Sales, General and Administrative Expense**

	Six Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Sales, general and administrative expense	\$ 26,666	\$ 25,224	\$ 1,442	6%
<i>Percentage of service revenue</i>	<i>41%</i>	<i>36%</i>		

The increase in sales, general and administrative expense for the six months ended June 30, 2010 compared to the prior year period was primarily attributable to the restructuring charge of \$1.1 million during the three months ended June 30, 2010 and severance costs of \$0.4 million relating to the departure of our former chief operating officer in February 2010. In addition, we saw higher legal costs related to the legal matters described in Part II Item 1 Legal Proceedings. These increases were partially offset by lower stock compensation expense.

**Intangible Asset Impairment**

Our intangible assets include those acquired as part of our July 2007 acquisition of MPS and ERS from SPRPA and the related agreements entered into between us and SPRPA. As a result of settlement negotiations described in this report for the three months ended March 31, 2010, we determined that an impairment indicator was present related to the professional services and noncompete agreements we entered into with and trademarks acquired from, SPRPA. We concluded that \$27.3 million of the \$49.6 million carrying value of these intangible assets was impaired. As a result, we recorded a non-cash intangible impairment charge of \$27.3 million in the three months ended March 31, 2010.

**Goodwill Impairment**

We recorded a \$68.7 million goodwill impairment charge during the three months ended March 31, 2009 due to our determination that the fair value of goodwill was less than the carrying value. The goodwill impairment charge was non-cash and did not affect our operations, cash flow or cash position.

**Interest Expense**

	Six Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Interest expense	\$ 6,828	\$ 3,628	\$ 3,200	88%
<i>Percentage of service revenue</i>	<i>10%</i>	<i>5%</i>		

The increase in interest expense for the six months ended June 30, 2010 compared to the prior year period was primarily attributable to the discontinuation of hedge accounting for all our interest rate swap contracts effective January 1, 2010. As a result, the year-to-date change in the fair value of the ineffective hedges of \$4.0 million was recorded to interest expense.

**Income Tax Expense (Benefit)**

	Six Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Income tax expense (benefit)	\$ 25	\$ (10,186)	\$ 10,211	(100)%
Effective tax rate	(0.5%)	17.8%		

The change in our income tax expense was due primarily to the tax benefit resulting from the goodwill impairment charge recorded during the three months ended March 31, 2009. We recorded a non-cash goodwill impairment charge in the three months ended March 31, 2009, a portion of which is not deductible for tax purposes, resulting in an effective tax rate different than the statutory rate.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

The difference in effective tax rates was primarily attributable to the Company recording a non-cash goodwill impairment charge in the quarter ended March 31, 2009, a portion of which was not deductible for tax purposes.

**Table of Contents****Income (Loss) from Discontinued Operations, Net of Tax**

	Six Months Ended June 30,		Change	
	2010	2009	In Dollars	Percentage
Income (loss) from discontinued operations, net of tax	\$ (18,364)	\$ (3,497)	\$ (14,867)	(425)%

For the six months end June 30, 2010, the discontinued operations generated a net loss of \$18.4 million on \$10.2 million in revenue, as compared to a net loss of \$3.5 million for the three months ended June 30, 2009 on \$10.8 million in revenue. The net loss for the six months ended June 30, 2010 included \$27.3 million in intangible asset impairment compared to \$6.9 million in goodwill impairment for the six months ended June 30, 2010.

**Non-GAAP Financial Performance Measures**

We present non-GAAP financial measures because we believe that they are a useful indicator of our performance and ongoing operations, provide consistency and comparability with our past financial performance and facilitate investor comparisons of our operating performance with our peer companies. However, it is important to note that the presentation of adjusted net income and adjusted earnings per diluted share are not measures of financial performance under GAAP and should not be considered a substitute for or superior to GAAP. The non-GAAP financial measures we report are as follows:

**Adjusted revenue including discontinued operations** We define adjusted revenue including discontinued operations as the sum of revenue from continuing operations and revenue from discontinued operations. The following table reconciles revenue, the most directly comparable GAAP financial performance measure, to adjusted revenue including discontinued operations, a non-GAAP financial performance measure:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenue from continuing operations	\$ 33,560	\$ 36,760	\$ 65,165	\$ 70,342
Add back impact of:				
Revenue from discontinued operations	5,269	5,580	10,212	10,797
Adjusted revenue including discontinued operations	\$ 38,829	\$ 42,340	\$ 75,377	\$ 81,139

**Adjusted net income** We define adjusted net income as net income excluding the tax effected impact of (i) the non-cash expense related to our stock-based compensation, (ii) the non-cash expense associated with the amortization of intangibles associated with acquisitions, (iii) the non-cash expenses (or credits) for adjustments to our IBNR reserve (incurred but not reported medical liability reserves), (iv) non-cash interest expense, (v) restructuring costs, (vi) the non-cash charges for goodwill or intangible asset impairments, (vii) non-cash adjustments for deferred tax balances and (viii) other one-time, non-cash expenses accounted for from time to time. These other expenses may occur in future periods, but the amounts recognized can vary from period to period and do not directly relate to our ongoing operations.

**Adjusted net income from continuing operations** We define adjusted net income from continuing operations as net income from continuing operations excluding the tax effected impact of (i) the non-cash expense related to our stock-based compensation, (ii) the non-cash expense associated with the amortization of intangibles associated with acquisitions, (iii) the non-cash expenses (or credits) for adjustments to our IBNR reserve (incurred but not reported medical liability reserves), (iv) non-cash interest expense, (v) restructuring costs, (vi) the non-cash charges for goodwill or intangible asset impairments, (vii) non-cash adjustments for deferred tax balances and (viii) other one-time, non-cash expenses accounted for from time to time. These other expenses may occur in future periods, but the amounts recognized can vary from period to period and do not directly relate to our ongoing operations.

**Adjusted net income from discontinued operations** We define adjusted net income discontinued operations as net income (loss) from discontinued operations excluding the tax effected impact of (i) the non-cash expense associated with the amortization of intangibles associated with acquisitions, (ii) non-cash interest expense, (iii) the non-cash charges for goodwill or intangible asset impairments, and (iv) non-cash adjustments for deferred tax balances.



**Table of Contents**

*Adjusted diluted earnings per share* We define adjusted diluted earnings per share in the same manner as each of the non-GAAP measures described above.

**Adjusted net income**

The following table reconciles net income, the most directly comparable GAAP financial performance measure, to adjusted net income, a non-GAAP financial performance measure:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Net income (loss)	\$ (4,185)	\$ 2,094	\$ (23,380)	\$ (50,519)
Tax effected impact of:				
Non-cash stock based compensation	2,522	946	3,390	1,589
Amortization of intangible assets	1,774	1,059	2,824	2,212
IBNR medical malpractice loss reserves	(533)		(533)	242
Non-cash interest expense	2,295	337	3,581	883
Goodwill and intangible asset impairment			16,927	54,029
Restructuring costs	632		902	
Non-cash adjustment to deferred tax balances	(50)		(50)	
Adjusted net income (loss)	\$ 2,455	\$ 4,436	\$ 3,661	\$ 8,436

The following table reconciles earnings (loss) per diluted share, the most directly comparable GAAP financial performance measure, to adjusted net income per diluted share and adjusted net income per diluted share, both non-GAAP financial performance measures:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Net income (loss)	\$ (0.18)	\$ 0.08	\$ (0.99)	\$ (1.90)
Tax effected impact of:				
Non-cash stock based compensation	0.11	0.03	0.14	0.06
Amortization of intangible assets	0.07	0.04	0.12	0.08
IBNR medical malpractice loss reserves	(0.02)		(0.02)	0.01
Non-cash interest expense	0.09	0.01	0.15	0.03
Goodwill and intangible asset impairment			0.71	2.03
Restructuring costs	0.03		0.04	
Non-cash adjustment to deferred tax balances				
Adjusted net income (loss)	\$ 0.10	\$ 0.16	\$ 0.15	\$ 0.31

**Adjusted net income from continuing operations**

The following table reconciles net income (loss) from continuing operations, the most directly comparable GAAP financial performance measure, to adjusted net income from continuing operations, a non-GAAP financial performance measure:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Net income (loss) from continuing operations	\$ (2,566)	\$ 1,662	\$ (5,016)	\$ (47,022)
Tax effected impact of:				
Non-cash stock based compensation	2,181	946	3,049	1,589
Amortization of intangible assets	565	611	1,159	1,310
IBNR medical malpractice loss reserves	(533)		(533)	242
Non-cash interest expense	1,660	337	2,946	883
Goodwill and intangible asset impairment				49,755
Restructuring costs	632		902	
Non-cash adjustment to deferred tax balances	(336)		(336)	
Adjusted net income from continuing operations	\$ 1,603	\$ 3,556	\$ 2,171	\$ 6,757

**Table of Contents**

During the three months ended June 30, 2010, our adjusted net income from continuing operations decreased \$2.0 million compared to the year ago period. During the six months ended June 30, 2010, our adjusted net income from continuing operations decreased \$4.6 million year over year. The decline in both periods was primarily due to the effects of lower average prices.

The following table reconciles earnings (loss) per diluted share from continuing operations, the most directly comparable GAAP financial performance measure, to adjusted earnings per diluted share from continuing operations per diluted share, a non-GAAP financial performance measure:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Net income (loss) from continuing operations	\$ (0.11)	\$ 0.06	\$ (0.21)	\$ (1.77)
Tax effected impact of:				
Non-cash stock based compensation	0.09	0.04	0.12	0.06
Amortization of intangible assets	0.02	0.02	0.05	0.05
IBNR medical malpractice loss reserves	(0.02)		(0.02)	0.01
Non-cash interest expense	0.07	0.01	0.12	0.03
Goodwill and intangible asset impairment				1.87
Restructuring costs	0.03		0.04	
Non-cash adjustment to deferred tax balances	(0.01)		(0.01)	
Adjusted net income from continuing operations	\$ 0.07	\$ 0.13	\$ 0.09	\$ 0.25

**Adjusted net income from discontinued operations**

The following table reconciles net income (loss) from discontinued operations, the most directly comparable GAAP financial performance measure, to adjusted net income from discontinued operations, both non-GAAP financial performance measures:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Net income (loss) from discontinued operations	\$ (1,619)	\$ 432	\$ (18,364)	\$ (3,497)
Tax effected impact of:				
Non-cash stock based compensation	341		341	
Amortization of intangible assets	1,209	448	1,665	902
Non-cash interest expense	635		635	
Goodwill and intangible asset impairment			16,927	4,274
Non-cash adjustment to deferred tax balances	286		286	
Adjusted net income from discontinued operations	\$ 852	\$ 880	\$ 1,490	\$ 1,679

**Table of Contents**

The following table reconciles earnings (loss) per diluted share from discontinued operations, the most directly comparable GAAP financial performance measure, to adjusted earnings per diluted share from discontinued operations a non-GAAP financial performance measure:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income (loss) from discontinued operations	\$ (0.07)	\$ 0.02	\$ (0.78)	\$ (0.13)
Tax effected impact of:				
Non-cash stock based compensation	0.01		0.01	
Amortization of intangible assets	0.05	0.01	0.07	0.03
Non-cash interest expense	0.03		0.03	
Goodwill and intangible asset impairment			0.72	0.16
Non-cash adjustment to deferred tax balances	0.01		0.01	
Adjusted net income from discontinued operations	\$ 0.03	\$ 0.03	\$ 0.06	\$ 0.06

**Liquidity and Capital Resources***Capital Resources*

Our capital resources include cash, cash equivalents and marketable securities. The tables below highlight significant aspects of our capital resources.

	June 30, 2010	December 31, 2009
	(In millions)	
<b>Capital resources</b>		
Cash and cash equivalents	\$ 24.3	\$ 26.3
Marketable securities		6.0
Total	\$ 24.3	\$ 32.3

*Cash Flow Activities*

The table and discussion below highlight significant aspects of our cash flow activities.

	Six Months Ended June 30, (In millions)	
	2010	2009
<b>Cash flow activities</b>		
Net cash provided by (used in):		
Operating activities	\$ 10.8	\$ 14.5
Investing activities	13.7	(7.1)
Financing activities	(26.5)	(7.4)
Increase (decrease) in cash and cash equivalents	\$ (2.0)	\$

*Operating Activities*



## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

We fund our operations primarily from cash flows generated by our operating activities and the incurrence of debt. Net cash provided by operating activities for the six months ended June 30, 2010 and 2009 was \$10.8 million and \$14.5 million, respectively, a decrease of \$3.7 million. The decrease in cash from operating activities primarily resulted from pricing declines of 10%.

---

## **Table of Contents**

### *Investing Activities*

Net cash flows provided by investing activities were \$13.7 million for the six months ended June 30, 2010, compared with \$7.1 million used in investing activities for the six months ended June 30, 2009. The increase in net cash from investing activities compared to the same period a year ago primarily resulted from \$9.5 million received as part of the SPRPA settlement and \$6.0 million in proceeds from maturities of marketable securities in the first six months of 2010, compared to \$5.0 million in purchases of marketable securities during the first six months of 2009. During the first six months of 2010, U.S. Treasuries held matured, and we chose not to repurchase those securities but rather placed the funds into a money market account.

### *Financing Activities*

Net cash used in financing activities was \$26.5 million for the six months ended June 30, 2010, compared with \$7.4 million for the six months ended June 30, 2009. The increase in net cash used in financing activities compared to the same period a year ago primarily reflects the principal payment of \$26.0 million on our long-term debt as part of the agreement with our lenders following the closing of the settlement with SPRPA, compared to a \$6.5 million purchase of shares of our common stock in the first six months of 2009.

### *Financial Condition and Liquidity*

We expect our short and long-term liquidity needs to consist primarily of working capital, capital expenditures, including information technology and any future acquisitions. We will also have liquidity needs if we elect to repurchase shares of our common stock and if we elect or are required to make principal payments under our credit agreement. We intend to fund future liquidity needs from current capital resources and cash generated from operations. We believe our capital resources will be sufficient to meet our anticipated cash needs for at least the next 12 months.

Our credit agreement contains customary affirmative, negative and financial covenants, including, among other requirements, negative covenants that restrict our ability to create liens, enter into mergers and acquisitions, pay dividends, repurchase stock, incur indebtedness, make investments and make capital expenditures, and financial covenants that limit the maximum leverage we can maintain at any one time. Our term loan is subject to mandatory repayment under certain circumstances, including in connection with our receipt of proceeds from certain issuances of equity or debt, sales of assets and casualty events. In addition, our credit agreement requires a principal payment in the amount equal to 50% of our Excess Cash Flow (as defined in our credit agreement) if the Total Leverage Ratio (as defined in our credit agreement) is at or above 2.5 at year end. Furthermore, if our Total Leverage Ratio exceeds 4.0 on any trailing four quarter basis, our obligation to repay all borrowings could be accelerated. As of June 30, 2010, our Total Leverage Ratio was 3.08. In connection with the settlement with SPRPA, we were required to obtain the consent of the lenders of the term loan and agreed to pay \$26.0 million on the day of the settlement and make an additional payment of \$10.0 million on or prior to June 30, 2011. Pursuant to such consent, should we be required to make an Excess Cash Flow payment with respect to fiscal years 2010 and 2011, such payment will be reduced by an amount equal to these repayments. As of June 30, 2010 we were in compliance with all covenants contained in our credit agreement and expect to remain in compliance with these covenants throughout 2010.

Our financial results will be impacted as a result of the settlement with SPRPA. In the first six months of 2010, we generated an aggregate of \$10.2 million, or approximately 14% of our total revenue, from our original agreements with SPRPA. As a result of the settlement, beginning July 1, 2010, we no longer derive revenue from such agreement or related profits that we have historically generated from SPRPA. As a result, our Total Leverage Ratio under our credit agreement could exceed 2.5 for the year, which in turn would trigger a mandatory principal repayment by us equal to 50% of our Excess Cash Flow for such year, or 4.0, which could result in the acceleration of our obligation to repay all of our borrowings under our credit agreement. If we fail to meet either of our Total Leverage Ratio tests in the future and we are required to make a mandatory repayment of a portion of the principal of our term loan, or if our obligations under our term loan are accelerated as a result of our default, our financial condition would be materially adversely impacted.

As described more fully above under *Recent Developments Resolution of Dispute with SPRPA and Related Transaction*, pursuant to the consent we have received from our lenders, we will make an additional \$10.0 million principal payment to the lenders on or before June 30, 2011. We expect to fund such principal payments out of available cash and investments and from payments received as part of the settlement.

Pursuant to the terms of our credit agreement, we are required to calculate our Total Leverage Ratio on a pro forma basis, meaning that we must calculate our Total Leverage Ratio assuming the SPRPA settlement transaction took place at the beginning of the trailing four quarter measurement period. As a result, even with the principal payment described above, we expect our Total Leverage Ratio in future periods to increase.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Finally, we may elect from time to time to make additional principal payments on our debt or cancel or change our interest rate swap agreements in order to enhance our capital structure as we did in prior years. We anticipate funding any such elective or required principal payments and any payments related to canceling or changing our interest rate swap agreements out of our available cash and cash equivalents. However, if our estimates of revenues, working capital and/or capital expenditure requests change or prove inaccurate, we may need to raise additional funds to satisfy any required principal payment. There can be no assurance that any such funds will be available at the time or times needed or available on terms acceptable to us. See Part II Item 1A Risk Factors We may need additional capital, which may not be available to us.

**Table of Contents***Off-Balance Sheet Arrangements*

There have been no significant changes to our off-balance sheet arrangements as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009.

*Contractual Obligations*

The following table presents a summary of our contractual obligations as of June 30, 2010:

	Payments Due Within				Total
	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years	
Long-term debt obligations (a)	\$ 10.5	\$ 0.8	\$ 40.5	\$ 0.0	\$ 51.8
Interest on long-term borrowings (b)	3.6	6.6	3.8	0.0	14.0
Operating lease commitments	2.4	4.3	1.2	1.0	8.9
Total contractual obligations	\$ 16.5	\$ 11.7	\$ 45.5	\$ 1.0	\$ 74.7

(a) See Note 4 of the Notes to Consolidated Financial Statements in Item 1.

(b) Actual interest paid in future years may differ from amounts shown in this table due to any future refinancing or repayment of our debt. Interest on our floating rate debt was calculated for all years using the effective rate as of June 30, 2010 including the impact of our interest rate swap contracts. The amounts given above do not include the unamortized amounts held within Accumulated Other Comprehensive Income which will be amortized to interest expense. See Note 9 of the Notes to Consolidated Financial Statements in Item 1.

Total contractual obligations exclude our liability for uncertain tax positions of \$2.3 million as of June 30, 2010 because we were unable to make reasonable estimates as to the period of settlement with the respective taxing authorities.

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk***Foreign Currency Exchange Risk*

During the periods covered by this quarterly report, substantially all of our customers are in the United States and thus revenue is denominated in U.S. dollars. Although some of our affiliated radiologists work from our centralized reading facilities in Australia and Switzerland, the professional service fees we pay to our affiliated radiologists are denominated primarily in U.S. dollars. As a result, only our support personnel and facility costs in those countries present foreign currency exchange risks. Because we are not currently subject to material foreign currency exchange risk, we have not, to date, entered into any foreign exchange hedging contracts. If a weakening U.S. dollar requires us to increase the amounts we pay to our affiliated radiologists in the future in order to maintain a constant level of compensation, our results of operations and cash flows could be affected. Currently, any foreign exchange risks are related to the foreign currency exchange rates between the U.S. dollar and the Australian dollar and between the U.S. dollar and the Swiss franc.

*Interest Rate Sensitivity*

As of June 30, 2010, we had cash and cash equivalents totaling \$24.3 million. The majority of these amounts was invested in interest-bearing money market accounts and is held for working capital purposes. We had no marketable securities outstanding as of June 30, 2010.

As of June 30, 2010, we had \$51.8 million in variable rate debt. Because of the five interest rate swap contracts entered into during the fourth quarter of 2008, this outstanding debt is not subject to interest rate fluctuation until such contracts expire on June 30, 2014. While in effect, these interest rate swap contracts will maintain an effective interest rate on our outstanding debt of approximately 4.95%. The contracts were initiated to maintain compliance with debt requirements and to protect us against changes in the interest payments associated with its variable-rate

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

long-term debt, and therefore are considered cash flow hedges. As a result, as long as the swap contracts are deemed highly effective, changes in the fair value of the swap contracts are recorded as either an asset (a gain position) or a liability (a loss position) on the balance sheet, with the offset recorded in accumulated other comprehensive income, a separate component of stockholders' equity.

---

## **Table of Contents**

During 2009 we determined that two of the five interest rate swap contracts were not effective. As a result, changes in the fair value of these ineffective contracts were recorded as a component of interest expense in our statement of operations in 2009 and for the six months ended June 30, 2010.

We determined that the three remaining effective interest rate swap contracts no longer meet the criteria for treatment as cash flow hedges under the guidance of ASC Topic 815 and related interpretations. As a result, we have prospectively discontinued cash flow hedge accounting for these interest rate swap contracts as of January 1, 2010. Changes in the fair value of these interest rate swap contracts subsequent to January 1, 2010 have been recorded as a component of interest expense in our statement of operations in during the six months ended June 30, 2010 and will be on a prospective basis.

For more information on our interest rate hedging activities, see Note 9 Derivative Financial Instruments, included in Part I Item 1 of this report.

### **ITEM 4. Controls and Procedures**

#### ***Evaluation of Disclosure Controls and Procedures***

As of June 30, 2010, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2010, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) were effective.

#### ***Changes in Internal Control over Financial Reporting***

During the three months ended June 30, 2010, there were no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect such internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. Legal Proceedings**

We are involved in various legal proceedings arising in the ordinary course of our business activities. We maintain insurance policies with coverages that we believe are appropriate in light of the risks attendant to our business, and believe that the resolution of the current claims will not have a material adverse impact on our consolidated results of operations, cash flows or our financial position. However, depending on the amount of damages resulting from a current or future claim, an unfavorable resolution of a claim could materially affect our future results of operations, cash flows or financial position.

As we have discussed in previous periodic reports, we were involved in a dispute with SPRPA regarding allegations made by SPRPA that we were in breach of certain of our obligations under our agreements with SPRPA. Effective June 30, 2010, we entered into a series of agreements with SPRPA, its affiliates and a third party pursuant to which we settled the legal dispute between the parties, terminated our relationships with SPRPA and unwound the transactions we entered into with SPRPA in July 2007. In connection with the settlement, we received an up-front payment \$12.0 million and expect to receive ongoing periodic payments totaling \$14.0 million, resulting in an aggregate amount paid to us of \$26.0 million.

In our Annual Report on Form 10-K, we reported that, on December 17, 2009, a putative shareholder class action lawsuit was filed against us and certain of our former officers in the U.S. District Court for the District of Idaho. The case is captioned *City of Marysville General Employees Retirement System v. NightHawk Radiology Holdings, Inc., et al.*, Case No. CIV 09-659-N-CWD. On July 13, 2010, plaintiffs filed an amended complaint under the new caption *In re Nighthawk Radiology Holdings, Inc. Securities Litigation*, Master File No. 09-cv-00659 (EJL/CWD). The complaint purports to be brought on behalf of a class of persons who purchased or otherwise acquired our stock during the period May 2, 2007 to May 7, 2008, and asserts claims under Section 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. Plaintiffs contend that the Company and the individual defendants violated the federal securities laws by issuing false and misleading statements concerning the Company's operations, business, and prospects during the purported class period, and thereby artificially increased the price of the Company's stock. Plaintiffs seek unspecified compensatory damages, interest, and attorneys' fees and costs.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

On April 29, 2010, the court issued an order appointing Plymouth County Contributory Retirement System ( Plymouth ) as lead plaintiff, and approving Plymouth 's selection of the law firms Scott + Scott LLP and Holland & Hart LLP as co-lead counsel. Pursuant to a stipulated case management order, defendants have until September 13, 2010 to move to dismiss the complaint. Management intends to vigorously defend against these claims.

**Table of Contents**

**ITEM 1A. Risk Factors**

*YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING AN INVESTMENT DECISION. OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION OR OPERATING RESULTS COULD BE MATERIALLY ADVERSELY AFFECTED BY ANY OF THESE RISKS. THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE DUE TO ANY OF THESE RISKS AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT. IN ASSESSING THE RISKS DESCRIBED BELOW, YOU SHOULD ALSO REFER TO THE OTHER INFORMATION CONTAINED IN THIS REPORT, INCLUDING OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, BEFORE DECIDING TO PURCHASE ANY SHARES OF OUR COMMON STOCK.*

*We operate in a rapidly evolving market, which makes it difficult to evaluate our business and prospects.*

Our industry is relatively new and is rapidly evolving. As a result, our current business and future prospects are difficult to evaluate. You must consider our business and prospects in light of the risks and difficulties we encounter as an early leader in a rapidly evolving market. Some of these risks relate to our potential inability to:

effectively manage our business and technology,

effectively manage our operating costs as the price for our services declines,

continue to provide consistently high levels of service quality as we expand the scale of our business,

develop new services that complement our existing business,

acquire additional customers and maintain current customers in a highly competitive environment,

market our services to our customers due to regulatory rules governing reassignment of payments, which could affect our customers ability to collect fees for services provided by our affiliated radiologists,

effectively manage the integration of companies that we may acquire in the future,

manage growth in personnel and operations,

effectively manage our medical liability risk, and

recruit and retain radiologists and other key personnel.

We may not be able to successfully address these and the other risks described in this report. Failure to adequately do so would harm our business and cause our operating results to suffer. Furthermore, our early operating history resulted in historical revenue growth rates that we will likely not be able to repeat, and therefore will not be indicative of our future results of operations. As a result, the price of our common stock could decline.

*The market in which we participate is competitive and we expect competition to increase in the future, which will make it more difficult for us to sell our services and has resulted and may continue to result in pricing pressure, reduced revenue and reduced market share.*



## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

The market for professional radiology services and business process services is competitive and rapidly changing, barriers to entry are relatively low, and with the introduction of new technologies and market entrants, we expect competition to continue to intensify in the future. In fact, in recent periods we have experienced an increase in competition from regional providers of services similar to ours. If we fail to compete effectively, our operating results will be harmed. Some of our principal competitors, including our largest competitor, Virtual Radiologic Corporation, (or VRC), offer their services at a lower price, which has resulted and may continue to result in pricing pressure and lost customers. If we are unable to maintain our current pricing or effectively revise the way we compensate our affiliated radiologists, our operating results would be negatively impacted. In addition, pricing pressures and increased competition would result in reduced revenue and reduced profits.

In addition, if companies larger than us enter the market through internal expansion or acquisition of one of our competitors, the change in the competitive landscape could adversely affect our ability to compete effectively. These competitors could have established customer relationships and greater financial, technical, sales, marketing and other resources than we do, and may be able to respond more quickly to new or emerging technologies or devote greater resources to the development, promotion and sale of their services. This competition could harm our ability to sell our services, which may lead to lower prices, reduced revenue and, ultimately, reduced market share.

***We may be unable to successfully expand our services beyond the off-hours emergency radiology market.***

A key part of our strategy to offset the moderation of growth in our provision of preliminary reads involves providing final reads and sub-specialty services; however, our efforts to provide these final reads and sub-specialty services, or any other services beyond our current services offerings and radiology solutions, may not result in significant revenue growth for us. The markets for final and sub-specialty reads are more complex than the market for preliminary reads. If we are to be successful in these markets, we will be required to develop, execute and maintain new sales and marketing efforts, as well as new information technology capabilities. In addition, our final and sub-specialty service offering requires our customers to navigate the billing and collecting rules related to the reads our affiliated physicians provide including the billing reassignment rules and the rules regarding where to bill for such services rules that are often cumbersome and difficult for our customers. As a result, our efforts to expand our services into these new markets may divert management resources from existing operations and require us to commit significant financial resources to an unproven business. If we are unable to effectively address the challenges that these new service offerings present, our business, financial condition and results of operations could be adversely affected.

## **Table of Contents**

***If our customers perceive that we are offering services that are competitive to theirs, some of our customers may terminate their agreements with us, which could adversely affect our business, financial condition and results of operation.***

Historically, some radiology groups have been concerned that teleradiology companies may potentially become competitive with them for their business. Our core mission has always been to work with and to support our radiology group customers and we are committed to acting consistently with our mission of supporting our radiology group customers and not competing with them. Despite this, as the largest teleradiology company in the industry, we are particularly vulnerable to the potential that there could be speculation or misperception by some radiology groups that we may become competitive with their business, which may result in some customers choosing to discontinue doing business with us. If this were to occur, our business, financial condition and results of operations could be adversely affected.

***If our arrangements with our affiliated radiologists or our customers are found to violate state laws prohibiting the corporate practice of medicine or fee splitting, our business, financial condition and our ability to operate in those states could be adversely impacted.***

The laws of many states, including states in which our customers are located, prohibit us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. We enter into agreements with our affiliated radiologists pursuant to which the radiologists render professional medical services using their independent judgment and discretion with no influence by NightHawk. In addition, we enter into agreements with our customers to deliver professional radiology interpretation services in exchange for a service fee. We structure our relationships with our affiliated radiologists and our customers in a manner that we believe is in compliance with prohibitions against the corporate practice of medicine and fee splitting. If any state regulatory or similar authority determines that we are engaged in the corporate practice of medicine or that the payment of service fees to us by our customers constitutes fee splitting, we could be subject to civil and criminal penalties and could be required to restructure or terminate the applicable contractual arrangements. A determination that these arrangements violate state statutes, or our inability to successfully restructure our relationships with our affiliated radiologists to comply with these statutes, could eliminate customers located in certain states from the market for our services, which would have a materially adverse effect on our business, financial condition and operations.

***Our growth strategy depends on our ability to recruit and retain qualified radiologists. If we are unable to do so, our future growth would be limited and our business and operating results would be harmed.***

Our success is dependent upon our continuing ability to recruit and retain qualified radiologists. An inability to recruit and retain radiologists would have a material adverse effect on our ability to service our customers and grow our revenues and would adversely affect our results of operations. We face competition for radiologists from other healthcare providers, including radiology groups, teleradiology companies, research and academic institutions, government entities and other organizations. If we are unable to effectively recruit and retain qualified radiologists, our business, financial condition and results of operations could be adversely affected.

***If our affiliated radiologists are characterized as employees, we would be subject to employment and withholding liabilities and may be subject to prohibitions against the corporate practice of medicine.***

We structure our relationships with our affiliated radiologists in a manner that we believe results in an independent contractor relationship, not an employee relationship. An independent contractor is generally distinguished from an employee by his or her degree of autonomy and independence in providing services. A high degree of autonomy and independence is generally indicative of a contractor relationship, while a high degree of control is generally indicative of an employment relationship. Although we believe that our affiliated radiologists are properly characterized as independent contractors, tax or other regulatory authorities may in the future challenge our characterization of these relationships. If the Internal Revenue Service, or IRS, (or other state, federal or foreign courts) were to determine that our affiliated radiologists are employees, and not independent contractors, we would be required to withhold income taxes, to withhold and pay social security, Medicare and similar taxes and to pay unemployment and other related payroll taxes, would be liable for unpaid past taxes by our affiliated radiologists and may be subject to penalties, all of which may materially harm our business and operating results. In connection with its audit of our tax filing for the 2006 tax year, the IRS reviewed our characterization of our affiliated radiologists as independent contractors. As a result of that review, we received a letter on August 27, 2009 stating that no changes to the tax as reported would be made and no further examination of this matter will be made by the IRS. However we cannot provide assurances that future audits would be consistent with this conclusion. If, in the future, the IRS were to reach a different conclusion, we believe we could successfully modify our relationships with our affiliated radiologists to address such an outcome. However, if we were unable to successfully implement this new relationship with our affiliated radiologists, our business and results of operations could be adversely affected.

---

## **Table of Contents**

***If our customers terminate their agreements with us or if our customers' businesses materially decline, our financial condition and operating results could be adversely affected.***

Our revenue is derived primarily from fee-for-service billings to our radiology group customers. Our agreements with our customers generally provide for one-year terms and automatically renew for successive one-year terms unless terminated by our customers or us upon 30 days prior notice. Our customers may elect not to renew their contracts with us, they may seek to renegotiate the terms of their contracts or they may choose to reduce or eliminate our services. For example, due to a number of competitive factors, we saw an 11% decrease in read volumes that resulted from the cumulative impact of customers that we lost over the last 12 months. In addition, in response to overall market conditions or concerns about pressures on their incomes, our radiology group customers may choose to perform more of their own off-hours coverage for their hospital sites, resulting in lower volumes, or they may choose to terminate their agreements with us. If our customers decrease their utilization of our services, or if they terminate or cancel their relationships with us, whether due to competitive factors or not, our business, financial condition and results of operations could be adversely affected. In addition, if our radiology group customers' agreements with the hospitals that they serve are terminated, or if our radiology group customers' businesses begin to decline for other reasons (such as a material increase in the rate of uninsured patients or uncollectible accounts), our business, financial condition and results of operations could be adversely affected.

***If SPRPA does not satisfy its payment obligations with respect to the \$14 million aggregate principal amount promissory note it issued to us, our results of operations and cash flows would be adversely affected.***

In June 2010, we resolved a dispute between us and SPRPA. In connection with such settlement, SPRPA issued to us an unsecured promissory note in the aggregate principal amount of \$14 million, which is payable to us over four years. If SPRPA defaults on its payment obligation under the note, our results of operations and cash flows would be adversely affected.

***We have been subject to medical liability claims and may become subject to additional claims or other harmful lawsuits, which could cause us to incur significant expenses and may require us to pay significant damages if not covered by insurance.***

Our business entails the risk of medical liability claims against our affiliated radiologists and us. We or our affiliated radiologists are subject to ongoing medical liability claims in the ordinary course of business. In addition, in some instances, these medical liability proceedings include allegations by plaintiffs that our business practices violate the appropriate standard of care and that, as a result, a court should institute punitive damages against us. Although we maintain medical liability insurance for ourselves and our affiliated radiologists with coverage that we believe is appropriate in light of the risks attendant to our business, successful medical liability claims could result in substantial damage awards which exceed the limits of our insurance coverage. In addition, medical liability insurance is expensive and insurance premiums may increase significantly in the future, particularly as we continue to grow our final and sub-specialty services. As a result, adequate medical liability insurance may not be available to our affiliated radiologists or us in the future at acceptable costs or at all.

Any claims made against us, including any claims that our business practices violate the standard of care, that are not fully covered by insurance could be costly to defend against, result in substantial damage awards against us and divert the attention of our management and our affiliated radiologists from our operations, which could adversely affect our operations and financial performance. In addition, any claims might adversely affect our business or reputation.

In addition to medical liability claims, we may also become subject to other litigation proceedings that, if not fully covered by insurance, could be costly to defend against, result in substantial damage awards against us and divert the attention of our management.

We indemnify our radiology group customers and hospital customers against damages or liabilities that they may incur as a result of the actions of our affiliated radiologists or us. We also indemnify some of our affiliated radiologists against medical liability claims. Our indemnification obligations are typically payable only to the extent that damages incurred are not covered by insurance.

We have also assumed and succeeded to substantially all of the obligations of the businesses that we have acquired. Medical liability claims may be asserted against us for events that occurred prior to these acquisitions.

We are also dependent upon the financial health of our medical liability insurance provider. Currently our medical malpractice provider is Chartis, Inc., an insurance subsidiary of American International Group (or AIG). We believe Chartis is adequately collateralized, however we cannot guarantee its financial health. Should AIG or Chartis not have the funds available to cover claims made against us or our radiologists, our business, the financial condition and results of operations could be adversely affected.

***If our security measures are breached and unauthorized access is obtained to patient or customer data, we may face liabilities and our system may be perceived as not being secure, causing customers to curtail or stop using our services, which could lead to a decline in***

*revenues.*

We are required to implement administrative, physical and technological safeguards to ensure the security of the patient data that we create, process or store. These safeguards may fail to ensure the security of patient or customer data, thereby subjecting us to liability, including civil monetary penalties and possible criminal penalties. If our security measures are breached, whether as a result of third party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to patient or customer data, our reputation will be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access to systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventive measures.

---

**Table of Contents**

***Enforcement of federal and state laws regarding privacy and security of patient information may adversely affect our business, financial condition or operations.***

The use and disclosure of certain healthcare information by healthcare providers and their business associates have come under increasing public scrutiny. The federal standards under HIPAA establish rules concerning how individually identifiable health information may be used, disclosed and protected. Historically, state law has governed privacy issues and HIPAA preserves these laws to the extent they are more protective of a patient's privacy or provide the patient with more access to his or her health information. As a result of the implementation of the HIPAA privacy and security regulations, many states are considering revisions to their existing privacy, security and breach notification laws and regulations that may or may not be more stringent or burdensome than the federal HIPAA privacy, security and breach notification provisions. In addition, the recently enacted HITECH Act now empowers state attorneys general to enforce HIPAA's privacy and security provisions, including the new federal breach notification requirements. We must operate our business in a manner that complies with all applicable laws, both federal and state, and which does not jeopardize the ability of our customers to comply with all applicable laws to which they are subject. We believe that our operations are consistent with these legal standards. Nevertheless, these laws and regulations present risks for healthcare providers and their business associates that provide services to patients in multiple states. Because these laws and regulations are recent and few have been interpreted by government regulators or courts, our interpretations and activities may be challenged. If a challenge to our activities is successful, it could have an adverse effect on our operations. In addition, even if our interpretations of HIPAA and other federal and state laws and regulations are correct, we could be held liable for unauthorized uses or disclosures of patient information as a result of inadequate systems and controls to protect this information or due to the theft of information by unauthorized computer programmers who penetrate our network security. Lastly, new legislation to broaden privacy and security rules has been introduced in Congress and in numerous states which may require that we change our operations.

***Recently-enacted or future changes in healthcare regulation may constrain or require us to restructure our operations, which could negatively impact our business and operating results.***

The healthcare industry is heavily regulated and has recently been the subject of significant legislative action. Our ability to operate profitably will depend in part upon our ability (and that of our affiliated radiologists, our customers and their radiologists) to continue to operate effectively in the new health care environment. With the changes enacted by the recently-passed Patient Protection and Affordable Care Act, we believe that there will be continued pressure on the overall imaging market and our customers by, among other things, a potential reduction in the growth in, or overall number of, diagnostic imaging procedures performed, and a reduction in the payments to radiology groups and facilities for both the technical component and professional component of such procedures. Any reduction in demand for diagnostic imaging, as well as reduced reimbursement to groups and facilities that utilize our services could in turn adversely affect our business.

Our business could also be adversely affected by regulatory changes at the federal or state level that impose new requirements for licensing, new restrictions on reimbursement for medical services by government programs, new pretreatment certification requirements for patients seeking radiology procedures, or new limitations on services that can be performed by us. In addition, federal, state and local legislative bodies have adopted and continue to consider medical cost containment legislation and regulations that have restricted or may restrict reimbursement to entities providing services in the healthcare industry and referrals by physicians to entities in which the physicians have a direct or indirect financial interest or other relationship. For example, Medicare has adopted a regulation that limits reimbursement for the technical component when multiple diagnostic tests are performed during a single session at medical facilities other than hospitals. Any of these or future reimbursement regulations or policies could limit the number of diagnostic tests our customers order and could have a material adverse effect on our business.

Although we monitor legal and regulatory developments and modify our operations from time to time as the regulatory environment changes, we may not be able to adapt our operations to address every new regulation, and such regulations may adversely affect our business. In addition, although we believe that we are operating in compliance with applicable federal and state laws, our business operations have not been scrutinized or assessed by judicial or regulatory agencies. We cannot assure you that a review of our business by courts or regulatory authorities would not result in a determination that adversely affects our operations or that the healthcare regulatory environment will not change in a way that will restrict our operations.

***Our business could be materially affected if a HHS-OIG study results in adverse modifications to Medicare payments for emergency room imaging.***

In its Fiscal Year 2010 Work Plan, the HHS-OIG lists as a work in progress its current inspection of the appropriateness of payments for hospital emergency department x-rays and interpretations. It is possible that, in the final report, the HHS-OIG could recommend changes to CMS reimbursement rules regarding emergency imaging. If the HHS-OIG were to make such recommendations and, if such recommendations were adopted, such changes could adversely affect our operations.



## **Table of Contents**

***Our operating results are subject to seasonal fluctuation, which makes our results difficult to predict and could cause our performance to fall short of quarterly expectations.***

Historically, we have experienced increased demand for and revenues from our services during the second and third fiscal quarters of each year. We believe that these increases are a result of increased outdoor and transportation activities and a greater utilization of service hours during the summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower revenues than those experienced during the second and third quarters. We may or may not continue to experience this or other seasonality in the future. These seasonal factors may lead to unpredictable variations in our quarterly operating results and cause the trading price of our common stock to decline. Additionally, our ability to schedule adequate radiologist coverage during the seasonal period of increased demand for our services may affect our ability to provide appropriate turnaround times in our services to clients.

***Interruptions or delays in our information systems or in network or related services provided by third-party suppliers could impair the delivery of our services and harm our business.***

Our operations depend on the uninterrupted performance of our information systems, which are substantially dependent on systems we have developed internally since our inception as well as systems provided by third parties over which we have little control. Failure to maintain reliable information systems, or disruptions in our information systems could cause disruptions and delays in our business operations which could have a material adverse effect on our business, financial condition and results of operations.

We rely on broadband connections provided by third party suppliers to route digital images from hospitals in the United States to our facilities in Australia, Switzerland and the United States. Any interruption in the functioning of our internal systems or in the availability of the network connections between the hospitals and our affiliated physicians (regardless of location) would reduce our revenue and profits. Frequent or persistent interruptions in our services could cause permanent harm to our reputation and brand and could cause current or potential customers to believe that our systems are unreliable, leading them to switch to our competitors. Because our customers may use our services for critical healthcare services, any system failures could result in damage to our customers' businesses and reputation. These customers could seek significant compensation from us for their losses, and our agreements with our customers do not limit the amount of compensation that they may receive. Any claim for compensation, even if unsuccessful, would likely be time consuming and costly for us to resolve.

Our systems are vulnerable to damage or interruption, including damage and/or interruption due to earthquakes, floods, fires, power loss, telecommunication failures, terrorist attacks, computer viruses, break-ins, sabotage, and acts of vandalism. We do not carry business interruption insurance to protect us against losses that may result from interruptions in our service as a result of system failures.

Finally, from time to time, we upgrade, replace or expand our information systems. If we fail to successfully manage these activities, we could experience disruptions and delays in our operations, which could have a material adverse effect on our business.

***Hospital privileging requirements or physician licensure laws may limit our market, and the loss of hospital privileges or state medical licenses held by our affiliated radiologists could have a material adverse affect on our business, financial condition and results of operations.***

Each of our affiliated radiologists must be granted privileges to practice at each hospital from which the radiologist receives radiological images and must hold a license in good standing to practice medicine in the state in which the hospital is located. The requirements for obtaining and maintaining hospital privileges and state medical licenses vary significantly among hospitals and states. If a hospital or state restricts or impedes the ability of physicians located outside of the United States to obtain privileges or a license to practice medicine at that hospital or in that state, the market for our services could be reduced. In addition, any loss of existing privileges or medical licenses held by our affiliated radiologists could impair our ability to serve our existing customers and have a material adverse effect on our business, financial condition and results of operations.

Many of the hospital privileges held by our affiliated radiologists were issued pursuant to a standard promulgated by The Joint Commission that allows the local hospital to rely upon the credentialing and privileging processes performed by us with respect to our affiliated radiologists, a process called "privileging by proxy". Essentially, because we are a Joint Commission-accredited facility, other Joint Commission-accredited facilities can rely on our processes as opposed to duplicating work already performed in accordance with approved standards. However, over the past few years, the Centers for Medicare and Medicaid Services, or CMS, has increasingly expressed concerns regarding this ability for hospitals to rely on the processes of another institution. In response to the CMS position, The Joint Commission has recently announced that the standards allowing this practice will expire in July 2010.

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

In light of the planned changes adopted by The Joint Commission, we are working with our customers that have historically relied upon these standards to institute new credentialing processes that will help them comply with the new standards once they become effective. Although we have made significant progress, because of the additional workload that is inherent in any new process, these customers have been requesting to credential and privilege fewer physicians than are currently privileged at those sites. These changes have required us to adapt many of the administrative processes we perform related to our affiliated physicians, including our credentialing, privileging and scheduling processes. If we are not able to adapt our processes effectively, our financial condition and results of operations could be negatively impacted.



---

**Table of Contents**

***Medicare and Medicaid rules governing reassignment of payments could affect our customers' ability to collect fees for services provided by our affiliated radiologists and our ability to market our services to our customers.***

The majority of our customers are radiology practices. These customers, and not us, typically bill and receive payments from Medicare and/or Medicaid for professional services which were either performed by our affiliated radiologists that are U.S.-based or performed by the customer's radiologist after submission of the preliminary reads provided by our affiliated radiologists. Medicare and Medicaid generally prohibit a physician who performs a covered medical service from reassigning to anyone else (including to other physicians) the performing physician's right to receive payment directly from Medicare or Medicaid, except in certain circumstances. We believe that the services provided by our affiliated radiologists satisfy one or more of the exceptions to this prohibition, but the various Medicare carriers and state Medicaid authorities may interpret these exceptions differently than we do. Because Medicare and Medicaid payments may comprise a significant portion of the total payments received by our customers for the services of our U.S.-based affiliated radiologists, if it were determined that we do not qualify for an exception, our customers could be prohibited from billing Medicare and/or Medicaid for the services of our U.S.-based affiliated radiologists and this would cause a material adverse effect on our ability to market our services and on our business and results of operations. Future laws or regulations, moreover, may require that we bill Medicare or Medicaid directly for new services we provide to our customers. Should this occur, we would either be required to forgo business with such customers or be required to design, develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid.

Medicare reimbursement rules currently provide that the proper Medicare carrier to pay physician claims is the Medicare carrier for the region in which the physician or practice providing the service is located, rather than the Medicare carrier for the region in which the patient receiving the services is located. Many of our affiliated radiologists are located in a Medicare region that is different from the Medicare region in which the patient and treating hospital are located. Since it is incumbent on our customers to file with the proper Medicare carrier in order to receive payment, it may be necessary for our customers to enroll with additional Medicare carriers in order to properly submit claims for reimbursement. To the extent that our customers are unwilling or unable to do so, they may be unwilling to use our services unless we were to submit the claims. Should this occur, we would either be required to forgo business with such customers or be required to design, develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid. If we are unable to effectively address these challenges, our business, financial condition and results of operations could be adversely affected.

***Changes in the rules and regulations governing Medicare's and Medicaid's payment for medical services could affect our revenues, particularly with respect to final reads.***

Although most reads we provide are preliminary reads rather than final reads, we are providing an increasing number of final and sub-specialty reads. Cost containment pressures on Medicare and Medicaid could result in a reduction in the amount that the government will pay for these reads, which could cause pricing pressure on our services. Should that occur, we could be required to lower our prices, or our customers could elect to provide the reads themselves or obtain such services from one of our competitors, and not utilize the services of our affiliated radiologists, which would have a material adverse effect on our business, results of operations and financial condition.

***We may be subject to less favorable levels of payment based upon third party payor fee schedules.***

Many patients are covered by some form of private or government health insurance or other third party payment program. Third party payors generally establish fee schedules or other payment authorization methods for various procedures that govern which procedures will be reimbursed by the third party payors and the amount of reimbursement. To the extent that such schedules impact the rates at which third party payors are willing to pay the healthcare providers with whom we contract to provide imaging services, we are indirectly impacted by such fee schedules. However, if we were to negotiate direct payment arrangements with third party payors in the future, we would be directly impacted by such schedules. In addition, there is no guarantee that Medicare, state Medicaid programs, or commercial third party payors will continue to cover professional radiology services. For example, in some states, the Medicaid program budgets have been either cut or funds diverted to other programs, which have resulted in limiting the enrollment of participants. This has resulted in an increasing number of bankruptcies and difficulty in collecting accounts receivable at hospitals in certain states. Any reduction or elimination in coverage for our services could adversely impact our business.

***Changes in the healthcare industry or litigation reform could reduce the number of diagnostic radiology procedures ordered by physicians, which could result in a decline in the demand for our services, pricing pressure and decreased revenue.***

Changes in the healthcare industry directed at controlling healthcare costs and perceived over-utilization of diagnostic radiology procedures could reduce the volume of radiological procedures performed. For example, in an effort to contain increasing imaging costs, as part of the overall healthcare reform efforts, the U.S. government is considering what some managed care organizations and private insurers have already adopted, namely, instituting pre-authorization policies which require physicians to pre-clear orders for diagnostic radiology procedures before those procedures can be performed. If pre-clearance protocols are broadly instituted by Medicare and/or throughout the healthcare industry, the

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

volume of radiological procedures could decrease, resulting in pricing pressure and declining demand for our services. In addition, it is often alleged that many physicians order diagnostic procedures even when the procedures may have limited clinical utility in large part to establish a record for defense in the event of a medical liability claim. Changes in tort law could reduce the number of radiological procedures ordered for this purpose and therefore reduce the total number of radiological procedures performed each year, which could harm our operating results.

## **Table of Contents**

***We may not have adequate intellectual property rights in our brand, which could limit our ability to enforce such rights.***

Our success depends in part upon our ability to market our services under the NightHawk brand. However, we believe that the term NightHawk cannot be afforded trademark protection as it is a generic term used to describe the provision of off-hours radiology services. Other businesses may have prior rights in the brand names that we market under or in similar names, which could limit or prevent our ability to use these marks, or to prevent others from using similar marks. If we are unable to prevent others from using our brand names, or if others prohibit us from using them, our revenue could be adversely affected. Even if we are able to protect our intellectual property rights in such brands, we could incur significant costs in doing so.

***Any failure to protect our intellectual property rights in our workflow technology could impair its value and our competitive advantage.***

We rely heavily on our proprietary workflow technology to distribute radiological images to the appropriately licensed and privileged radiologist best able to provide the necessary clinical insight in the least amount of turnaround time. If we fail to protect our intellectual property rights adequately, our competitors may gain access to our technology, and our business may be harmed. We currently do not hold any patents with respect to our technology. Although we have filed an application for a patent covering our workflow technology, we may be unable to obtain patent protection for this technology. In addition, any patents we may obtain may be challenged by third parties. Accordingly, despite our efforts, we may be unable to prevent third parties from using or misappropriating our intellectual property.

***We may in the future become subject to intellectual property rights claims, which could harm our business and operating results.***

The information technology industry is characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. While we are not currently a party to any intellectual property litigation, if a third party asserts that our technology violates that third-party's proprietary rights, or if a court holds that our technology violates such rights, we may be required to re-engineer our technology, obtain licenses from third parties to continue using our technology without substantial re-engineering or remove the infringing functionality or feature. In addition, we may incur substantial costs defending any such claim. We may also become subject to damage awards, which could cause us to incur additional losses and harm our financial position. Monitoring potential infringement of and defending or asserting our intellectual property rights may entail significant expense. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

***We are dependent on our management team, and the loss of any key member of this team may prevent us from implementing our business plan in a timely manner.***

Our success depends largely upon the continued services of our executive officers, particularly David Engert, our President and Chief Executive Officer and David Sankaran, our Chief Financial Officer. The loss of either of these executive officers could have a material adverse effect on our business, financial condition, results of operations and the trading price of our common stock. The search for replacements for any of our executives could be time consuming and could distract our management team from the day-to-day operations of our business.

***If we fail to implement and maintain an effective system of internal controls, we may not be able to report our financial results in an accurate or timely manner, prevent fraud or comply with Section 404 of the Sarbanes-Oxley Act of 2002, which may harm our business and affect the trading price of our stock.***

Effective internal controls are necessary for us to provide reliable financial reports in a timely manner and to prevent fraud. We cannot assure you that we will maintain an effective system of internal controls in the future. If we fail to adequately staff and train our accounting and finance personnel to meet the demands of operating as a public company, including the requirements of the Sarbanes-Oxley Act of 2002, or fail to maintain adequate internal controls, any resulting material weakness in internal controls could prevent our management from concluding the internal controls are effective and impair our ability to prevent material misstatements in our financial statements, which could cause our business to suffer. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements in a timely manner or prevent fraud may negatively affect the trading price of our stock or result in stockholder litigation.

***We may be unable to enforce non-compete agreements with our affiliated radiologists.***

Our independent contractor agreements with our affiliated radiologists typically provide that the radiologists may not compete with us for a period of time, typically ranging from 180 days to one year, after the agreements terminate. These covenants not to compete are enforceable to varying degrees from jurisdiction to jurisdiction. In most jurisdictions, a covenant not to compete will be enforced only to the extent that it is

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

necessary to protect the legitimate business interest of the party seeking enforcement, that it does not unreasonably restrain the party against whom enforcement is sought and that it is not contrary to the public interest. This determination is made based upon all the facts and circumstances of the specific case at the time enforcement is sought. It is unclear whether our interests will be viewed by courts as the type of protected business interest that would permit us to enforce a non-competition covenant against the radiologists. A determination that these provisions are not enforceable could have a material adverse effect on us.

## **Table of Contents**

***If we acquire any companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.***

An element of our strategy is to pursue strategic acquisitions that are complementary to our business or offer us other strategic benefits. Acquisitions in which we may engage involve numerous risks, including:

difficulties or delays in integrating physician compensation models,

difficulties in integrating operations, technologies, services and personnel,

diversion of financial and management resources from existing operations,

risk of entering new markets,

potential write-offs of acquired assets,

potential loss of key employees, and

inability to generate sufficient revenue to offset acquisition costs.

We have in the past experienced, and may experience in the future, these difficulties as we integrate the operations of companies we acquire.

In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. We have made six acquisitions to date, and our management has experienced challenges in completing acquisitions and integrating acquired businesses with our operations. If we fail to properly evaluate and execute acquisitions, our business and prospects may be harmed.

***Enforcement of state and federal anti-kickback laws may adversely affect our business, financial condition or operations.***

Various federal and state laws govern financial arrangements among healthcare providers. The federal anti-kickback law prohibits the knowing and willful offer, payment, solicitation or receipt of any form of remuneration in return for, or with the purpose to induce, the referral of Medicare, Medicaid, or other federal healthcare program patients, or in return for, or with the purpose to induce, the purchase, lease or order of items or services that are covered by Medicare, Medicaid, or other federal healthcare programs. Similarly, many state laws prohibit the solicitation, payment or receipt of remuneration in return for, or to induce the referral of patients in private as well as government programs. Violation of these anti-kickback laws may result in substantial civil or criminal penalties for individuals or entities and/or exclusion from participating in federal or state healthcare programs. If we are excluded from federal or state healthcare programs, our customers who participate in those programs would not be permitted to continue doing business with us. We believe that we are operating in compliance with applicable law and believe that our arrangements with providers would not be found to violate the anti-kickback laws. However, these laws could be interpreted in a manner inconsistent with our operations.

***Because our customers submit claims to the Medicare program based on the services we provide, it is possible that a lawsuit could be brought against us or our customers under the federal False Claims Act, and the outcome of any such lawsuit could have a material adverse effect on our business, financial condition and operations.***

The Federal False Claims Act provides, in part, that the federal government may bring a lawsuit against any person whom it believes has knowingly presented, or caused to be presented, a false or fraudulent request for payment from the federal government, or who has made a false statement or used a false record to get a claim approved. The government has taken the position that claims presented in violation of the federal

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

anti-kickback law may be considered a violation of the Federal False Claims Act. The Federal False Claims Act further provides that a lawsuit brought under that act may be initiated in the name of the United States by an individual who was the original source of the allegations, known as the relator. Actions brought under the Federal False Claims Act are sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government and the court. Therefore, it is possible that lawsuits have been filed against us that we are unaware of or which we have been ordered by the court not to discuss until the court lifts the seal from the case. Penalties include fines ranging from \$5,500 to \$11,000 for each false claim, plus three times the amount of damages that the federal government sustained because of the act of that person. We believe that we are operating in compliance with the Medicare rules and regulations, and thus, the Federal False Claims Act. However, if we were found to have violated certain rules and regulations and, as a result, submitted or caused our customers to submit allegedly false claims, any sanctions imposed under the Federal False Claims Act could result in substantial fines and penalties or exclusion from participation in federal and state healthcare programs which could have a material adverse effect on our business and financial condition.

## **Table of Contents**

Federal regulatory and law enforcement authorities have recently increased enforcement activities with respect to Medicare and Medicaid fraud and abuse regulations and other reimbursement laws and regulations, including laws and regulations that govern our activities and the activities of teleradiologists. These increased enforcement activities may have a direct or indirect adverse affect on our business, financial condition and results of operations.

Additionally, some state statutes contain prohibitions similar to and possibly even more restrictive than the Federal False Claims Act. These state laws may also empower state administrators to adopt regulations restricting financial relationships or payment arrangements involving healthcare providers under which a person benefits financially by referring a patient to another person. We believe that we are operating in compliance with these laws. However, if we are found to have violated such laws, our business, results of operations and financial condition would be harmed.

***Changes in the governmental interpretation or enforcement of the federal prohibition on physician self-referral may adversely affect our business, financial conditions or operations.***

The federal Stark Law prohibits a physician from referring Medicare or Medicaid patients for the provision of designated health services by an entity in which the physician has an investment interest or with which the physician has entered into a compensation arrangement. Designated health services include both the professional and technical components of diagnostic tests using X-rays, ultrasound or other imaging services, CT, MRI, radiation therapy and diagnostic mammography services. Violation of the Stark Law may result in substantial civil penalties and/or exclusion from participation in federal health care programs for both the referring physicians and any entities that submit technical and/or professional component claims for any diagnostic tests ordered by those referring physicians. We believe that we have structured our arrangements between our affiliated radiologists and our customers in a manner that complies with applicable law. However, this law could be interpreted in a manner inconsistent with our arrangements.

***The trading price of our common stock has been volatile and will likely remain volatile.***

The trading prices of many publicly-traded companies are highly volatile, particularly companies such as ours that have relatively limited operating histories and are operating in an evolving industry. Since our initial public offering in February 2006, the trading price of our common stock has been subject to wide fluctuations. Factors that will continue to affect the trading price of our common stock include:

variations in our operating results,

announcements of new services, strategic alliances or significant agreements by us or by our competitors,

recruitment or departure of key personnel,

changes in the estimates of our operating results or changes in recommendations by any securities analysts that follow our common stock, and

market conditions in our industry, the industries of our customers and the economy as a whole.

In addition, if the market for healthcare stocks or healthcare services or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us.

***We may need additional capital, which may not be available to us.***

We currently anticipate that our existing capital resources and cash generated from future operations will be sufficient to meet our liquidity needs for at least the next 12 months. However, we may need to raise additional funds if our estimates of revenues, working capital and/or

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

capital expenditure requirements change or prove inaccurate or in order for us to respond to unforeseen technological or marketing hurdles or to take advantage of unanticipated opportunities. There can be no assurance that any such funds will be available at the time or times needed or available on terms acceptable to us.

Furthermore, if our total leverage ratio under our credit agreement exceeds the thresholds provided for in the credit agreement, we may be required to repay all or a portion of our term loan borrowings under our credit agreement. See Part I Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Financial Condition and Liquidity of this report for more information. Our financial results will be impacted as a result of the settlement with SPRPA. In the first six months of 2010, we generated an aggregate of \$10.2 million, or approximately 14%, of our total revenue, from our original agreements with SPRPA. As a result of the settlement, beginning July 1, 2010, we will not derive any revenue from such agreements or related profits that we have historically generated from SPRPA. As a result, our total leverage ratio could exceed thresholds that would trigger obligations to repay some or all of our borrowings under our credit agreement. If we are required to make a mandatory repayment of a portion of the principal of our term loan, or if our obligations under our term loan are accelerated as a result of our default, our financial condition would be materially adversely impacted.



---

## **Table of Contents**

***If securities analysts do not publish research or reports about our business, or if they downgrade our stock, the price of our stock could decline.***

The trading market for our common stock will rely in part on the availability of research and reports that third-party industry or financial analysts publish about us. There are many large, publicly-traded companies active in the healthcare services industry, which may mean it will be less likely that we receive widespread analyst coverage. Furthermore, if one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

***Adverse changes in general economic conditions could adversely affect our operating results.***

Our success depends upon our ability to continue to provide our services to our customers and the willingness of our customers to engage us for these services. The willingness and ability of our customers to engage us for our services depends upon a number of factors, including broader economic conditions, conditions of the radiology marketplace and perceptions of such conditions by our customers. Adverse changes in the broader U.S. economy or in the radiology marketplace may have an adverse impact on the behavior of our customers and the extent to which they are willing to engage us for our services. In addition, we may experience difficulty collecting accounts receivable in a timely manner, or at all, if our customers are adversely affected by prevailing economic conditions. Any of these factors could, in turn, have a material adverse effect on our business, financial condition, results of operations and cash flows.

***A change in our customer composition or general economic conditions may impact our collection rates.***

An increasing number of our customers are hospitals or hospital groups. As changes occur in general economic conditions, hospitals may be required to modify their budgets and/or move funds to other programs as directed by their management or changes in government funding. Recently, we have noticed an increasing number of hospitals becoming insolvent as government funds decrease to hospitals in certain states. If this trend continues and impacts our customers, our collection rates may decrease and our bad debt expense increase which, in turn, could have a material adverse effect on our business, financial condition, results of operations and cash flows.

***We are exposed to foreign currency exchange risks, which could harm our business and operating results.***

We maintain significant operations in Australia and Switzerland, and are exposed to adverse changes in exchange rates associated with the expenses of our operations in these countries. However, we do not currently engage in any hedging transactions to mitigate these risks. Although from time to time we review our foreign currency exposure and evaluate whether we should enter into hedging transactions, we may not adequately hedge against any future volatility in currency exchange rates and, if we engage in hedging transactions, the transactions will be based on forecasts which later may prove to be inaccurate. Any failure to hedge successfully or anticipate currency risks properly could adversely affect our operating results.

In addition, 20% of our affiliated radiologists live in Australia and Switzerland, but receive compensation from us in U.S. dollars. Any relative weakness in the U.S. dollar compared to the Australian dollar or Swiss franc may increase the cost of living for our affiliated radiologists and make it less attractive for our affiliated radiologists to sign or renew their service contracts with us.

***Provisions in our certificate of incorporation and bylaws and Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.***

Our certificate of incorporation and bylaws contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

establish a classified board of directors so that not all members of our board are elected at one time,

provide that directors may only be removed for cause ,

## Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

authorize the issuance of blank check preferred stock that our board could issue to increase the number of outstanding shares and to discourage a takeover attempt,

eliminate the ability of our stockholders to call special meetings of stockholders,

prohibit stockholder action by written consent, which has the effect of requiring all stockholder actions to be taken at a meeting of stockholders,

provide that the board of directors is expressly authorized to make, alter or repeal our bylaws, and

establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company.

**Table of Contents**

**ITEM 6. Exhibits**

**Exhibit**

<b>Number</b>	<b>Description</b>
10.39*	2010 Performance-Based Incentive Program approved by the Compensation Committee of the Board of Directors on April 29, 2010
10.40*	Professional Services Agreement dated May 1, 2010 between the Company and Peacefield Radiology, LLC (a professional medical association wholly-owned by Dr. Tim Myers).
10.41	Membership Interest Purchase Agreement dated June 30, 2010 among the Company and FutureRad, LLC.
10.42	Termination Agreement dated June 30, 2010 among the Company, Nighthawk Radiology Services, LLC, Midwest Physicians Services, LLC, St. Paul Radiology, P.A. and Midwest Radiology, LLC.
10.43	Promissory Note dated June 30, 2010 issued to the Company by St. Paul Radiology, P.A.
10.44	Mutual General Release and Waiver dated June 30, 2010 between the Company and Nighthawk Radiology Services, LLC, on the one hand, and St. Paul Radiology, P.A., Cornerstone Radiology, PLC, Midwest Radiology, LLC, SPR Holdings, LLC, SPR Holdings II, LLC, Physicians Services Building, LLC and Physicians Imaging Building, LLC, on the other hand.
10.45	Consent to Amended and Restated Credit Agreement effective as of June 30, 2010 among the Company, the Lenders and Morgan Stanley Senior Funding, Inc., as Administrative Agent.
31.1	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Indicates a management contract or compensatory plan or arrangement.

**Table of Contents**

**SIGNATURES**

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

**NIGHTHAWK RADIOLOGY HOLDINGS, INC.**

Date: August 05, 2010

By: */s/* DAVID M. SANKARAN  
David M. Sankaran

**Executive Vice President and Chief Financial Officer**

**(Principal Financial and Accounting Officer)**