AMERIPATH INC
Form 10-Q
August 14, 2006
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

or

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

Commission File Number: 000-22313

AMERIPATH, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**65-0642485**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
7111 Fairway Drive, Suite 400	
Palm Beach Gardens, Florida	**33418**
(Address of Principal Executive Offices)	**(Zip Code)**

(561) 712-6200

(Registrant s Telephone Number, Including Area Code)

Not Applicable

(Former Name, Former Address and Formal Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant is a larger accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-Accelerated Filer x

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

The number of shares of common stock of the registrant outstanding as of August 14, 2006 was 100.

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AMERIPATH, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 8,319	$ 3,998
Restricted cash	26,960	26,684
Accounts receivable, net	126,954	84,968
Inventories	6,833	2,327
Deferred tax assets, net	11,139	10,909
Other current assets	7,734	4,963
Total current assets	187,939	133,849
PROPERTY AND EQUIPMENT, NET	93,019	49,196
OTHER ASSETS:		
Goodwill	841,960	608,160
Identifiable intangibles, net	214,388	165,878
Other	33,110	27,066
Total other assets	1,089,458	801,104
TOTAL ASSETS	$ 1,370,416	$ 984,149
LIABILITIES AND STOCKHOLDER S EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 78,261	$ 59,823
Accrued interest	11,154	9,721
Current portion of long-term debt	2,189	354
Other current liabilities	1,422	218
Total current liabilities	93,026	70,116
LONG -TERM LIABILITIES:		
Long-term debt	620,012	479,136
Other liabilities	48,037	33,228
Deferred tax liabilities, net	38,114	16,952
Total long-term liabilities	706,163	529,316
COMMITMENTS AND CONTINGENCIES		

STOCKHOLDER S EQUITY:		
Common stock, $.01 par value, 100 shares issued and outstanding at June 30, 2006 and December 31, 2005	1	1
Additional paid-in capital	552,813	369,427
Retained earnings	18,413	15,289
Total stockholder s equity	571,227	384,717
TOTAL LIABILITIES AND STOCKHOLDER S EQUITY	$ 1,370,416	$ 984,149

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
NET REVENUES:				
Total net revenues	$ 191,692	$ 143,634	$ 362,628	$ 277,514
OPERATING COSTS AND EXPENSES:				
Cost of services	107,940	74,276	204,866	147,776
Selling, general and administrative expenses	38,994	27,162	74,745	52,352
Provision for doubtful accounts	18,972	18,804	38,812	36,440
Amortization expense	2,900	3,474	6,755	6,779
Merger-related charges	1,198		1,784	
Gain on sale of practice				(454)
Total operating costs and expenses	170,004	123,716	326,962	242,893
INCOME FROM OPERATIONS	21,688	19,918	35,666	34,621
OTHER INCOME (EXPENSES):				
Interest expense	(14,902)	(11,707)	(28,004)	(22,935)
Change in value of derivative	453	329	746	(291)
Write-off of deferred financing costs		(345)	(3,360)	(345)
Other income, net	559	180	897	284
Total other expenses, net	(13,890)	(11,543)	(29,721)	(23,287)
INCOME BEFORE INCOME TAXES	7,798	8,375	5,945	11,334
PROVISION FOR INCOME TAXES	2,580	3,315	2,817	4,515
NET INCOME	$ 5,218	$ 5,060	$ 3,128	$ 6,819

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2006	**2005**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,128	$ 6,819
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	10,262	5,160
Amortization	6,755	6,779
Loss on disposal of assets	61	92
Provision for doubtful accounts	38,812	36,440
Gain on sale of practice		(454)
Write-off of deferred financing costs	3,360	345
Change in value of derivative	(747)	291
Non cash stock option expense	592	
Changes in assets and liabilities (net of effect of acquisitions)		
Increase in accounts receivable	(52,729)	(46,413)
Increase in inventories	(827)	(216)
(Decrease) increase in other current assets	(1,184)	1,942
Increase in accrued interest	1,433	159
Increase (decrease) in other assets	(1,377)	(191)
(Decrease) increase in accounts payable and accrued expenses	(5,620)	1,740
Net cash provided by operating activities	1,919	12,493
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisitions of property and equipment	(24,041)	(14,015)
Cash paid for acquisitions and related costs, net of cash acquired	(168,685)	
Cash received from sale of managed practice		900
(Increase) decrease in restricted cash	(276)	1,553
Investment in common stock		(150)
Payments of contingent notes	(3,351)	(8,790)
Net cash used in investing activities	(196,353)	(20,502)
CASH FLOWS FROM FINANCING ACTIVITIES		
Debt issuance costs	(5,052)	(27)
Net payments on long term debt and capital leases	(2,346)	(244)
Proceeds from new term loan facility, net of payments	202,991	
Payments on former term loan facility	(99,049)	(11,701)
Proceeds from new revolving debt facility, net of payments	69,000	
Payments on former revolving debt facility	(30,000)	
Proceeds from former revolving debt facility		2,000
Proceeds from release of contingent note fund	14,390	
Contingent note proceeds	2,746	8,566
Equity investment by parent	46,075	

Net cash provided by (used in) financing activities	198,755	(1,406)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,321	(9,415)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,998	20,980
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 8,319	$ 11,565
SUPPLEMENTAL NON-CASH TRANSACTIONS		
Property and equipment acquired pursuant to capital leases	$	$ 552
Issuance of Ameripath Group Holdings, Inc. equity in relation to Specialty Laboratories, Inc. acquisition	$ 119,581	$
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during period for interest	$ 26,747	$ 22,887
Cash paid during period for taxes	$ 1,081	$ 1,621

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements, which include the accounts of AmeriPath, Inc. and its subsidiaries (collectively, AmeriPath or the Company), have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial reporting and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, such interim financial statements contain all adjustments (consisting of normal recurring items) considered necessary for a fair presentation of the Company s financial position, results of operations and cash flows for the interim periods presented. The results of operations and cash flows for any interim period are not necessarily indicative of results that may be expected for the full year.

The accompanying unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements, and the notes thereto, included in the Company s Form 10-K for the year ended December 31, 2005 and filed with the Securities and Exchange Commission (SEC) on March 28, 2006.

In order to maintain consistency and comparability between periods presented, certain amounts in the prior period s financial statements have been reclassified to conform to the financial statement presentation of the current period.

Note 2 The March 2003 Transaction

On December 8, 2002, Amy Holding Company and its wholly-owned subsidiary, Amy Acquisition Corp., entered into a merger agreement with the predecessor of AmeriPath pursuant to which Amy Acquisition Corp. merged with and into the predecessor, with AmeriPath continuing as the surviving corporation. Amy Holding Company and Amy Acquisition Corp. were Delaware corporations formed at the direction of Welsh, Carson, Anderson & Stowe IX, L.P, (WCAS). WCAS, its related investors and several employees of the Company owned 100% of the outstanding common stock of Holdings after the March 2003 Transaction. The March 2003 Transaction was approved by the Company s stockholders and subsequently consummated on March 27, 2003. As a result of the March 2003 Transaction, AmeriPath became a wholly-owned subsidiary of Amy Holding Company, which was renamed Ameripath Holdings, Inc. (Holdings).

The March 2003 Transaction was accounted for under the purchase method of accounting prescribed in SFAS No. 141, Business Combinations, (SFAS No. 141), with intangible assets recorded in accordance with SFAS No. 142, Goodwill and Other Intangible Assets , (SFAS No. 142). In accordance with the provisions of SFAS No. 142, no amortization of indefinite-lived intangible assets or goodwill is recorded.

As required under current guidance, any amounts recorded or incurred (such as goodwill or debt) by our parent as a result of the March 2003 Transaction should be pushed down and recorded on our financial statements. The following table summarizes the final allocation of the March 2003 Transaction based upon a valuation completed by an independent third-party valuation firm during September 2003.

Cash and equity contributed by WCAS	$ 319,667
Total liabilities assumed	587,801
Fair value of assets acquired	(676,458)
Excess purchase price (goodwill)	$ 231,010

In addition, Holdings issued to WCAS Capital Partners III, L.P., an investment fund affiliated with WCAS, $67.0 million in principal amount of Holdings senior subordinated notes and an agreed-upon number of shares of its common stock, for an aggregate purchase price of $67.0 million. The proceeds from this transaction were deposited into a Holdings company cash collateral account, which cash, subject to some exceptions, will be contributed to the Company from time to time to fund up to $67.0 million of future payments under the Company s contingent notes relating to acquisitions consummated prior to the March 2003 Transaction. As of June 30, 2006, approximately $48.3 million of the $67.0 million has been contributed to the Company to fund contingent note payments and approximately $14.4 million of the $67.0 million was contributed to the Company to help fund the Specialty Laboratories, Inc. acquisition. The lenders under the Company s Credit Facility have a first-priority security interest in all funds held in such cash collateral account.

Note 3 Recent Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). The Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and amends FASB

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Statement No. 95, *Statement of Cash Flows.* SFAS No. 123(R) focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow, as prescribed under current accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. In April 2005, the Securities and Exchange Commission adopted a new rule that amends the effective dates for SFAS No. 123(R). The Company adopted the accounting provisions of SFAS No. 123(R) on January 1, 2006.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods, the modified prospective or modified retrospective method. The modified prospective method requires compensation cost to be recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted, modified or settled after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date. The modified retrospective method includes the requirements of the modified prospective method described above, but also requires entities to restate, based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures, either (a) all prior periods presented or (b) prior interim periods of the year of adoption. The Company adopted SFAS No. 123(R) using the modified prospective method effective January 1, 2006. See Note 12 for more information regarding our adoption of SFAS No. 123(R).

Note 4 Acquisitions

On January 31, 2006, the Company completed its acquisition of Specialty Laboratories, Inc., (Specialty) an esoteric lab in Valencia, California in a transaction valued at approximately $334.0 million. In connection with the acquisition, the Company formed a new parent entity, Ameripath Group Holdings, Inc. (Group Holdings). Subsequent to the transaction Group Holdings is the new parent of Holdings, which remains the parent of Ameripath. Under the terms of the merger agreement, the Company acquired all common shares of Specialty common stock outstanding at closing for $13.25 per common share, or $317.4 million. The Company financed the acquisition through a combination of cash on hand, contribution of shares by Specialty s majority shareholder, additional cash equity of $46.1 million from Ameripath s majority stockholder, WCAS, the release of certain contingent note funds of $14.4 million from Holdings, and borrowings under Ameripath s new credit facility. The Company paid $197.8 million in cash and issued $119.6 million or 19,930,208 shares in Group Holdings stock. Group Holdings common stock was issued at $6.00 a share, which was based on our internal valuation and previous transactions with third parties. In addition, Ameripath paid $9.7 million in cash for outstanding stock options of Specialty. Pursuant to the terms of the merger agreement, Specialty s outstanding stock options became fully vested and exercisable and were canceled in exchange for the right to receive an amount, for each share subject to the stock option, equal to the excess of $13.25 per share over the exercise price per share of such option. The aggregate purchase price of approximately $334.0 million includes transaction costs of approximately $6.9 million consisting primarily of fees and expenses of investment bankers, attorneys, and accountants.

The purchase price of the acquisition is summarized below:

Cash paid for Specialty s outstanding common stock	$ 197,801
Group Holdings common stock issued	119,581
Cash paid for Specialty s outstanding stock options	9,662
Transaction costs incurred	6,949
Total purchase price	$ 333,993

The following table summarizes the fair value of the assets acquired and liabilities assumed in connection with the acquisition, as of the date of the acquisition, as accounted for under SFAS No. 141 *Business Combinations* , which requires the use of the purchase method of accounting. The intangible asset valuation was performed by an independent third-party valuation firm during March 2006. In accordance with SFAS No. 109 *Accounting for Income Taxes* , the Company recognized a deferred tax liability of $20.7 million related to both definite and indefinite-lived intangible assets acquired in the Specialty acquisition. The allocation of the purchase price is summarized below:

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Cash	$ 40,986
Accounts receivable, net	27,774
Property & equipment, net	30,104
Inventory	3,679
Prepaid expenses	1,814
Intangible assets	53,390
Other investments	2,545
Other	1,598
Goodwill	225,768
Total assets	387,658
Accounts payable	10,685
Other long term liabilities	2,114
Deferred tax liabilities	20,673
Accrued liabilities	20,193
Total liabilities	53,665
Net assets acquired	$ 333,993

On March 31, 2006, the Company also acquired one hospital based anatomic pathology practice in Denver, Colorado. For the first six months of 2005, the Company did not acquire any new practices. The accompanying unaudited condensed consolidated financial statements include the results of operations of the Company s acquisitions accounted for under the purchase method from the date acquired through June 30, 2006. The following unaudited pro forma information presents the consolidated results of operations for the six months ended June 30, 2006 and 2005 as if the acquisitions had been consummated on January 1, 2006 and 2005, respectively.

The unaudited pro forma information presented below is for illustrative information purposes only and is not necessarily indicative of results which would have been achieved or results which may be achieved in the future.

	Six months ended June 30, 2006	Six months ended June 30, 2005
Net revenues	$ 375,454	$ 354,656
Net income	222	2,691

Contingent Notes Related To Past Acquisitions

During the six months ended June 30, 2006 and 2005, the Company made contingent note payments of approximately $3.4 million and $8.8 million, respectively relating to previous acquisitions. If the maximum specified levels of income from operations for all acquired operations are achieved, the Company estimates that it would make aggregate maximum principal payments of approximately $5.3 million over the next two years. A lesser amount or no payments at all would be made if the stipulated levels of income from operations or other evaluation factors specified in each agreement were not met.

Note 5 Intangible Assets

Amortization expense of identifiable intangibles was approximately $2.3 million and $2.9 million for the three months ended June 30, 2006 and 2005. Amortization expense of identifiable intangibles was approximately $5.6 million for both the six months ended June 30, 2006 and 2005.

Amortization expense related to identifiable intangibles for each of the five succeeding fiscal years and thereafter as of June 30, 2006 is as follows:

Remainder of 2006	$ 4,740
2007	9,475

2008	8,643
2009	8,364
2010	8,187
2011	7,950
Thereafter	102,451

The weighted average amortization period for identifiable intangible assets is approximately 19.6 years.

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Note 6 Long-term Debt

Senior Subordinated Notes On March 27, 2003, in connection with the March 2003 Transaction, Amy Acquisition Corp. issued $275.0 million of 10 1/2% Senior Subordinated Notes due 2013. The Company assumed Amy Acquisition Corp. s obligations with respect to the notes upon consummation of the March 2003 Transaction. Interest became payable semi-annually in arrears beginning in October 2003. In February 2004, the Company issued an additional $75.0 million of its 10 1/2% Senior Subordinated Notes due 2013 at a premium price of 106% plus accrued interest. The net premium amount is included in Other liabilities on the consolidated balance sheets. The notes are unconditionally guaranteed, jointly and severally and on an unsecured senior subordinated basis, by certain of the Company s current and former subsidiaries. The notes and guarantees rank junior to all of the Company s and the subsidiary guarantors existing and future senior indebtedness, on par with all of the Company s and the subsidiary guarantors existing and future senior subordinated indebtedness and senior to all of the Company s and the subsidiary guarantors existing and future subordinated indebtedness.

The Company may redeem any of the notes at any time and from time to time beginning on April 1, 2008, in whole or in part, in cash at the specified redemption prices, plus accrued and unpaid interest to the date of redemption.

If a change in control of the Company occurs, subject to certain conditions, the Company must give holders of the notes an opportunity to sell the notes to the Company at a purchase price of 101% of the principal amount of the notes, plus accrued and unpaid interest to the date of the purchase of the notes by the Company.

The indenture governing the notes contains covenants that, among other things, limit the Company s ability and the ability of the Company s restricted subsidiaries to incur or guarantee additional indebtedness, pay dividends or make other equity distributions, purchase or redeem capital stock, make certain investments, enter into arrangements that restrict dividends from subsidiaries, transfer and sell assets, engage in certain transactions with affiliates and effect a consolidation or merger.

Credit Facility On January 31, 2006, in connection with the acquisition of Specialty, the Company terminated its existing senior credit facility and entered into a new senior credit facility (the New Credit Facility) with a syndicate of financial institutions led by Wachovia Bank and Citigroup Global Markets, Inc. The new senior credit facility consists of a $203.5 million term loan and a $95.0 million revolving credit facility. The Company borrowed $203.5 million of the term loan and $52.0 million of the revolving credit to fund a portion of the Specialty acquisition consideration, to pay certain transaction costs related to the acquisition, to refinance existing indebtedness of the Company and to pay related expenses with the acquisition.

The interest rates per annum applicable to loans under the New Credit Facility are, at the Company s option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period chosen by the Company, or a nine or twelve month period if agreed to by all participating lenders, plus an applicable margin percentage in each case.

The alternate base rate is the greater of (1) the prime rate or (2) one-half of 1% over the weighted average of rates on overnight federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate will be determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The facility also requires a commitment fee to be paid quarterly equal to 0.125% of any unused commitments under the revolving loan facility.

The New Credit Facility requires scheduled quarterly principal payments on the term loan in amounts equal to $508,750 on each of June 30, September 30, December 31 and March 31. On June 30, 2006, the Company made its mandatory payment of $508,750.

Indebtedness under the New Credit Facility is guaranteed by all of the Company s current restricted subsidiaries, certain of its future restricted subsidiaries and by Holdings. It is secured by a first priority security interest in substantially all of the Company s existing and future property and assets, including accounts receivable, inventory, equipment, general

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intangibles, intellectual property, investment property, other personal property, owned and material leased real property, cash and cash proceeds of the foregoing and a first priority pledge of the Company s capital stock and the capital stock of the guarantor subsidiaries.

The New Credit Facility requires that the Company comply on a quarterly basis with certain financial covenants, including an interest coverage ratio calculation, a fixed charge coverage ratio calculation and a maximum net senior leverage ratio calculation, which become more restrictive over time. In addition, the New Credit Facility includes negative covenants restricting or limiting the Company s ability and the ability of its subsidiaries to, among other things, incur, assume or permit to exist additional indebtedness or guarantees; incur liens and engage in sale leaseback transactions; make capital expenditures; make loans and investments; declare dividends, make payments or redeem or repurchase capital stock; engage in mergers, acquisitions and other business combinations; prepay, redeem or purchase certain indebtedness; amend or otherwise alter terms of our indebtedness; sell assets; transact with affiliates and alter the business that it conducts.

Letters of Credit

As of June 30, 2006, the Company had letters of credit outstanding totaling $13.9 million. The letters of credit secure payments under certain operating leases and insurance policies and expire at various dates in 2006 and 2007. Some of the letters of credit automatically decline in value over various lease terms. The letters of credit have annual fees averaging 2.4%. Available borrowings under the $95.0 million revolving credit facility are reduced by the notional balance outstanding on these letters of credit. In addition, the Company had $300,000 of surety bonds outstanding on June 30, 2006 to satisfy Florida Medicaid requirements.

Note 7 Derivative Instrument

In April 2004, the Company entered into a 2 1/2 year interest rate swap transaction which involves the exchange of fixed for floating rate interest payments without the exchange of the underlying principal amount. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense. The change in the market value of the derivative instrument is recognized in the consolidated statements of income. For the six months ended June 30, 2006 and 2005, the change in the value of the derivative was a gain of approximately $0.7 million and a loss of approximately $0.3 million, respectively, which is reflected in the accompanying consolidated statements of income. The agreement has a notional amount of $75.0 million. The Company receives interest on the notional amount if the LIBOR rate is less than 2.405% and pays interest on the notional amount if the LIBOR rate exceeds 2.405%. The floating rate resets every October 1 and April 1. In April 2005, the floating rate reset at 3.39% until October 2005. The Company locked in to a forward LIBOR rate contract for October 2005 through March 2006 at a rate of 4.216%. In April 2006, the floating rate reset at 2.405% until October 2006. This derivative instrument is being used by the Company to reduce interest rate volatility and associated risks arising from the fixed rate structure of their Senior Subordinated Notes, and is not held or issued for trading purposes.

Note 8 Commitments and Contingencies

During the ordinary course of business, the Company has become and may in the future become subject to legal actions and proceedings. The Company may have liability with respect to its employees and its pathologists and with respect to hospital employees who are under the supervision of its hospital-based pathologists. The majority of these pending legal proceedings involve claims of medical malpractice and most of those suits relate to cytology services. Based upon investigations conducted to date, the Company believes the outcome of any pending legal actions and proceedings, individually or in the aggregate, will not have a material adverse effect on the Company s financial condition, results of operations or liquidity. If the Company is ultimately found liable under the outstanding medical malpractice claims, there can be no assurance that medical malpractice insurance arrangements will be adequate to cover all such liabilities. The Company also may, from time to time, be involved with legal actions related to the acquisition of anatomic pathology operations, the prior conduct of acquired operations or the employment and restriction on competition of physicians. There can be no assurance that any costs or liabilities for which the Company becomes responsible in connection with these claims or actions will not be material or will not exceed the limitations of any applicable indemnification provisions or the financial resources of the indemnifying parties.

Healthcare Regulatory Environment and Reliance on Government Programs The healthcare industry in general, and the services that the Company provides, are subject to extensive federal and state laws and regulations. Additionally, a significant portion of the Company s net revenue is from payments by government-sponsored health care programs, principally Medicare and Medicaid, and is subject to audits and adjustments by applicable regulatory agencies. Failure to comply with any of these laws or regulations, the results of increased regulatory audits and adjustments, or changes in the interpretation of the coding of services or the amounts payable for the Company s services under these programs could have a material adverse effect on the Company s consolidated financial position and results of operations. The Company s operations are continuously subject to review and inspection by regulatory authorities.

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From time to time, we receive subpoenas from government officials. For instance, the Company has received subpoenas issued by the United States Attorney s office in Tampa, Florida seeking information with respect to an investigation relating to Medicare billing and possible financial inducements in connection with a Florida physician who is not an AmeriPath pathologist but was a client of AmeriPath. In addition, certain affiliates of the Company have received an investigative subpoena from the Florida Attorney General Medicaid Fraud Control Unit requesting copies of agreements that we have with certain hospitals and certain patient records. To the Company s knowledge, numerous other hospitals and facilities have received similar subpoenas, which may indicate a state-wide audit of pathology operations. Specialty Laboratories, Inc., a California corporation received a subpoena from the California Attorney General s Office. The subpoena seeks various documents including documents relating to billings to the Medicaid program with time frames ranging from three to ten years. The Company is providing or has provided information to the United States Attorney s Office, the Florida Attorney General s Office and California Attorney General s Office and intends to cooperate in the investigations. It is not possible at this point in either investigation to determine whether the government will pursue action against AmeriPath or to assess the merits of possible defenses AmeriPath might have to any such action. Accordingly, no assurances can be given regarding the ultimate outcome of these investigations.

Specialty Laboratories Asia Pte. Ltd., a Singapore corporation, (SLA), is 60% owned by Specialty Laboratories International Ltd., a British Virgin Islands corporation (SLIL) and a wholly-owned subsidiary of Specialty. SLA was headquartered in Singapore but, in early 1999, SLA ceased all operations and is currently insolvent. A former employee of SLA has obtained a judgment for $350,000 against SLA and a default judgment of approximately $2.0 million in a wrongful termination action against SLA filed by him in Singapore. The former employee has filed an action against SLA in San Diego Superior Court to attempt to collect on the Singapore judgment and has obtained a default judgment of approximately $2.5 million against SLA in California. Ameripath accrued for this matter at the time the Specialty acquisition was recorded.

In December 2003, Specialty was served with an action in which it was named as a defendant, together with certain of its former officers, SLIL, and multiple other parties located in Singapore and India, in a lawsuit brought in the High Court of the Republic of Singapore by Dragon Investment Company (Dragon), one of the shareholders in SLA. Dragon has also brought the lawsuit in the name of SLA as a derivative action. The lawsuit alleges, among other things, that SLA and Dragon suffered damages as a result of the winding up of the affairs of SLA and disposition of its assets. The lawsuit also alleges that certain of the defendants breached certain written agreements to allow Dragon to acquire more shares of SLA, that certain of Specialty s former officers conspired to run down and dissipate the assets of SLA, and that they fraudulently concealed their actions from Dragon and the other minority shareholder of SLA. Specialty has provided notice to the applicable insurance carriers. Ameripath accrued for this matter at the time the Specialty acquisition was recorded.

Note 9 Comprehensive Income

SFAS No. 130, *Comprehensive Income*, requires that an enterprise (a) classify items of other comprehensive income by their nature in the financial statements, and (b) display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet. For the six months ended June 30, 2006 and 2005, net income equaled comprehensive income.

Note 10 Segment Reporting

The Company operates in one reportable segment, the medical laboratory industry. Medical laboratories offer a broad range of testing services to the medical profession. The Company s testing services are categorized based upon the nature of the test: anatomic pathology, esoteric services, and dermatopathology. These testing services are used by physicians in the diagnosis, prognosis, monitoring and general management of diseases and other clinical conditions. The tests included in such services generally detect medically-significant abnormalities and visual patterns in blood, tissue samples and other specimens.

Note 11 Income Taxes

The Company s effective income tax rate was 47.4% and 39.8% for the six month periods ended June 30, 2006 and 2005, respectively. The increase in the tax rate is a result of an increase in the state income tax valuation allowance and non-deductible merger costs in connection with the acquisition of Specialty.

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Note 12 Stock Options

The Company grants stock options for a fixed number of common shares to employees and directors from time to time. As of June 30, 2006, approximately 40,938 shares are available for future issuance.

Prior to December 31, 2005, the Company accounted for its employee stock option plan using the intrinsic method under APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and related interpretations. The Company applied the provision of APB No. 25 in accounting for its employee stock option plan, and because the exercise price of its options was equal to or greater than the market value of its options at the date of grant, no compensation cost has been recognized for the option plan in the consolidated statements of income for the sic months ended June 30, 2005.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the prospective transition method. Under that method, compensation cost recognized for the six months ended June 30, 2006 includes all share-based payments granted on or subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost related to stock awards granted is being recognized on a straight-line basis over the requisite service period. Results for the periods prior to January 1, 2006 have not been restated.

The Company calculates the fair value of employee stock options using a Black-Scholes-Merton option pricing model at the time the stock options are granted and that amount is amortized over the vesting period of the options, which is generally up to five years. The fair value for employee stock options for the six months ended June 30, 2006 was calculated based on the following assumptions: an average risk-free interest rate for the period of 4.6%; dividend yield of 0%; weighted-average volatility factor of 36.0%; and a weighted average expected life of the options of 6.5 years. The expected term was determined using the shortcut method described in Staff Accounting Bulletin Topic 14.D.2, which is based on a calculation to arrive at the midpoint between the vesting date and the end of the contractual term. The risk-free interest rate was based on the applied yield currently available on U.S treasury zero-coupon issues with a remaining term equivalent to the stock option award s expected term. The expected weighted-average volatility factor is based on the historical stock prices of two competitors of the Company whose shares are publicly traded over the most recent period, commensurate with the expected term of the stock option award.

In accordance wit the adoption of SFAS No. 123(R), the Company recorded compensation cost of approximately $449,000 and recognized a tax benefit for share-based compensation arrangements of $174,000 for the three months ended June 30, 2006. During the six months ended June 30, 2006, the Company recorded $592,000 in compensation cost and recognized a tax benefit for share-based compensation arrangements of $229,000.

As required by SFAS No. 123(R), the Company now estimates forfeitures of employee stock options and recognizes compensation cost only for those awards expected to vest. Forfeiture rates are determined for two groups of employees executives and management based on historical experience. Estimated forfeitures are now adjusted to actual forfeiture experience as needed.

The following table illustrates the effect on net income if the Company had applied the fair value recognition provisions of SFAS No. 123 to options granted under the Company s stock option plan for the six months ended June 30, 2005:

Net income reported	$ 6,819
Deduct: Total stock-based employee compensation expense determined under SFAS No. 123 for all awards, net of related tax effect	(453)
Pro forma net income	$ 6,366

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For purposes of this pro forma disclosure, the fair value of these options was estimated at the time of grant using a Black-Scholes-Merton option pricing model based on the following assumptions for the six months ended June 30, 2005: an average risk-free rate for the period of 4.1%; dividend yield of 0%; weighted-average volatility factor of 0%; and a weighted average expected life of the options of 8 years.

The following table summarizes information related to the Company s stock option activity for the six months ended June 30, 2006:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 2005	8,241,202	$ 6.00
Granted	3,677,271	6.00
Exercised		
Terminated/lapsed	(262,265)	6.00
Outstanding at June 30, 2006	11,656,208	6.00
Exercisable at June 30, 2006	3,631,072	$ 6.00

As of June 30, 2006, there was $8.6 million of total unrecognized compensation cost related to non-vested options, which is expected to be recognized, on a straight-line basis, over a weighted average period of 4.62 years.

Note 13 Subsequent Events

On July 17, 2006 SLA, SLIL, Dragon, Specialty and the other named defendants finalized a settlement agreement with respect to the pending lawsuit regarding all parties hereon and referenced in Note 8 Commitments and Contingencies of this Form 10-Q. The settlement agreement released all claims in the related lawsuits. The terms of such settlement agreement are confidential and approximate the amount accrued for this matter at the time the Specialty acquisition was recorded.

Note 14 Guarantor Subsidiaries

The following information is presented as required by regulations of the Securities and Exchange Commission in connection with the Company s 10 1/2% senior subordinated notes due 2013. This information is not routinely prepared for use by management. The operating and investing activities of the separate legal entities included in the Company s consolidated financial statements are fully interdependent and integrated. Accordingly, consolidating the operating results of those separate legal entities is not representative of what the actual operating results of those entities would be on a stand-alone basis. Operating expenses of those separate legal entities include intercompany charges for management fees and other services. Certain expense items and asset and liability balances that are applicable to the Company s subsidiaries are typically recorded in the books and records of AmeriPath, Inc. For purposes of this footnote disclosure, such balances and amounts have been pushed down to the respective subsidiaries either on a specific identification basis, or when such items cannot be specifically attributed to an individual subsidiary, have been allocated on an incremental or proportional cost basis to AmeriPath, Inc. and the Company s subsidiaries.

The following tables present consolidating financial information at June 30, 2006 and 2005, and December 31, 2005, for (i) AmeriPath, (ii) on a combined basis, the subsidiaries of AmeriPath that are guarantors of the Company s 10 1/2% Senior Subordinated Notes due 2013 (the Subsidiary Guarantors) and (iii) on a combined basis, the subsidiaries of AmeriPath that are not guarantors of the Company s 10 1/2% Senior Subordinated Notes due 2013 (the Non-Guarantor Subsidiaries). The maximum potential amount of future payments the subsidiary Guarantors could be required to make under the Guarantee is $350.0 million.

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Condensed Consolidating Balance Sheets:

As of June 30, 2006	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Assets					
Current assets:					
Cash and cash equivalents	$	$ 9,054	$ (735)		$ 8,319
Restricted cash		26,960			26,960
Accounts receivable, net	759	103,699	22,496		126,954
Inventories	321	6,288	224		6,833
Other current assets	1,122	14,762	2,989		18,873
Total current assets	2,202	160,763	24,974		187,939
Property & equipment, net	28,096	63,061	1,862		93,019
Goodwill		691,502	150,458		841,960
Identifiable intangibles, net	41,928	139,010	33,450		214,388
Investment in subsidiaries	959,034			(959,034)	
Other assets	18,668	12,365	2,077		33,110
Total assets	$ 1,049,928	$ 1,066,701	$ 212,821	$ (959,034)	$ 1,370,416
Liabilities and Stockholder s Equity					
Current liabilities:					
Accounts payable and accrued expenses	$ 26,313	$ 59,045	$ 4,057		$ 89,415
Current portion of long-term debt	2,189				2,189
Other current liabilities	1,119	303			1,422
Total current liabilities	29,621	59,348	4,057		93,026
Long-term debt	619,957	55			620,012
Other liabilities	17,354	27,078	3,605		48,037
Deferred tax liabilities, net	1,170	46,799	(9,855)		38,114
Total long-term liabilities	638,481	73,932	(6,250)		706,163
Intercompany payable (receivable)	244,194	(32,110)	32,264	(244,348)	
Stockholder s equity:					
Common stock	(1,272)	1,271	25	(23)	1
Additional paid-in capital	518,193	31,633	2,987		552,813
Retained earnings (deficit)	(379,289)	932,627	179,738	(714,663)	18,413
Total stockholder s equity	137,632	965,531	182,750	(714,686)	571,227
Total liabilities and stockholder s equity	$ 1,049,928	$ 1,066,701	$ 212,821	$ (959,034)	$ 1,370,416

As of December 31, 2005	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Assets					
Current assets:					
Cash and cash equivalents	$	$ 3,325	$ 673		$ 3,998
Restricted cash		26,684			26,684
Accounts receivable, net	450	64,421	20,097		84,968
Inventories	262	1,950	115		2,327

Other current assets	538	13,027	2,307		15,872
Total current assets	1,250	109,407	23,192		133,849
Property & Equipment, net	16,255	31,135	1,806		49,196
Goodwill, net		472,054	136,106		608,160
Other identifiable intangibles, net	16,937	116,791	32,150		165,878
Investment in subsidiaries	1,088,071			(1,088,071)	
Other assets	18,726	6,585	1,755		27,066
Total assets	$ 1,141,239	$ 735,972	$ 195,009	$ (1,088,071)	$ 984,149
Liabilities and Stockholder s Equity					
Current liabilities:					
Accounts payable and accrued expenses	$ 22,356	$ 41,698	$ 5,708		$ 69,762
Current portion of long-term debt	255	99			354
Total Current Liabilities	22,611	41,797	5,708		70,116
Long-term debt	479,056	80			479,136
Other liabilities	6,223	26,005	1,000		33,228
Deferred tax liabilities, net	536	20,926	(4,510)		16,952
Total long-term liabilities	485,815	47,011	(3,510)		529,316
Intercompany payable (receivable)	657,400	(294,073)	10,061	(373,388)	
Stockholder s equity:					
Common stock	(1,272)	1,271	25	(23)	1
Additional paid-in capital	334,807	31,633	2,987		369,427
Retained earnings (deficit)	(358,122)	908,333	179,738	(714,660)	15,289
Total stockholder s equity	(24,587)	941,237	182,750	(714,683)	384,717
Total liabilities and stockholder s equity	$ 1,141,239	$ 735,972	$ 195,009	$ (1,088,071)	$ 984,149

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Condensed Consolidating Statements of Operations:

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2006				
Net revenues	$	$ 297,828	$ 64,800	$ 362,628
Cost of services		181,939	22,927	204,866
Selling, general and administrative expenses	8,035	95,631	9,891	113,557
Amortization expense		5,976	779	6,755
Merger-related charges	1,784			1,784
Total operating costs and expense	9,819	283,546	33,597	326,962
(Loss) income from operations	(9,819)	14,282	31,203	35,666
Other income (expense)				
Interest expense	(27,994)	(10)		(28,004)
Management fee (A)		31,203	(31,203)	
Change in value of derivative	746			746
Write-off of deferred financing costs	(3,360)			(3,360)
Other, net	188	709		897
Total other expenses	(30,420)	31,902	(31,203)	(29,721)
(Loss) income before income taxes	(40,239)	46,184		5,945
Benefit (provision) for income taxes	19,073	(21,890)		(2,817)
Net (loss) income	$ (21,166)	$ 24,294	$	$ 3,128

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2005				
Net revenues	$	$ 215,394	$ 62,120	$ 277,514
Cost of services		123,244	24,532	147,776
Selling, general and administrative expenses	1,931	76,201	10,660	88,792
Amortization expense		5,996	783	6,779
Gain on sale of practice		(454)		(454)
Total operating costs and expense	1,931	204,987	35,975	242,893
(Loss) income from operations	(1,931)	10,407	26,145	34,621
Other income (expense)				
Interest expense	(22,830)	(105)		(22,935)
Management fee (A)		26,143	(26,143)	
Change in value of derivative	(291)			(291)
Write-off of deferred financing costs	(345)			(345)
Other, net	35	251	(2)	284
Total other expenses	(23,431)	26,289	(26,145)	(23,287)
(Loss) income before income taxes	(25,362)	36,696		11,334
Benefit (provision) for income taxes	10,103	(14,618)		(4,515)
Net (loss) income	$ (15,259)	$ 22,078	$	$ 6,819

(A) In accordance with the applicable management fee agreements, the Subsidiary Guarantors are the direct beneficiary of substantially all of the pre-tax income of the Non-Guarantor Subsidiaries.

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Condensed Consolidating Statements of Cash Flows:

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2006				
Cash flows from operating activities:				
Net (loss) income	$ (21,166)	$ 24,294	$	$ 3,128
Adjustments to reconcile net (loss) income to cash provided by operating activities	5,590	45,824	7,681	59,095
Changes in assets and liabilities which used cash, net of effects of acquisitions	(34,537)	(18,644)	(7,123)	(60,304)
Net cash (used) provided by operating activities	(50,113)	51,474	558	1,919
Cash flows used for investing activities	(150,988)	(43,399)	(1,966)	(196,353)
Cash flows provided by (used for) financing activities	201,101	(2,346)		198,755
(Decrease) increase in cash equivalents		5,729	(1,408)	4,321
Cash and cash equivalents, beginning of period		3,325	673	3,998
Cash and cash equivalents, end of period	$	$ 9,054	$ (735)	$ 8,319

	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
For the six months ended June 30, 2005				
Cash flows from operating activities:				
Net (loss) income	$ (15,936)	$ 22,755	$	$ 6,819
Adjustments to reconcile net (loss) income to cash provided by operating activities	2,275	38,500	7,878	48,653
Changes in assets and liabilities which provided (used) cash, net of effects of acquisitions	19,417	(56,158)	(6,238)	(42,979)
Net cash provided by operating activities	5,756	5,097	1,640	12,493
Cash flows used for investing activities	(4,594)	(13,489)	(2,419)	(20,502)
Cash flows used for financing activities	(1,162)	(244)		(1,406)
Decrease in cash equivalents		(8,636)	(779)	(9,415)
Cash and cash equivalents, beginning of period		19,513	1,467	20,980
Cash and cash equivalents, end of period	$	$ 10,877	$ 688	$ 11,565

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

The condensed consolidated financial statements contained in Item 1 include the accounts of AmeriPath, Inc. and subsidiaries (collectively, AmeriPath or the Company) as of and for the three and six months ended June 30, 2006 and 2005.

The following discussion of our financial condition and results of operations should be read together with our condensed consolidated financial statements and the accompanying notes included elsewhere in Item 1. Our fiscal year is the calendar year ending December 31.

AmeriPath is one of the leading anatomic pathology laboratory companies in the United States. We are a provider of physician-based anatomic pathology, dermatopathology, molecular diagnostic services, and other esoteric services to

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physicians, hospitals, clinical laboratories and surgery centers. We support community-based medicine by helping physicians provide excellent and effective care for their patients. During 2005, we processed and diagnosed over four million tissue biopsies. We believe that we are the only anatomic pathology laboratory company with substantial operations in both the outpatient and inpatient sections of the anatomic pathology services market.

We service an extensive referring physician base through our 48 laboratories, and we provide inpatient diagnostic and medical director services at 208 hospitals. We have operations in 24 states, providing us with a regional or local presence in 17 of the 30 most populous metropolitan areas of the United States. Our services are performed by over 390 pathologists, many of whom are leaders in their field. We have built our business by completing over 60 acquisitions of pathology laboratories and operations since our formation as a Delaware corporation in 1996, enabling us to build regional density in attractive geographic markets and to establish a platform for organic growth.

AmeriPath s industry is highly regulated. The manner in which licensed physicians can organize to perform and bill for medical services is governed by state laws and regulations. Business corporations like AmeriPath often are not permitted to employ physicians or to own corporations that employ physicians or to otherwise exercise control over the medical judgments or decisions of physicians.

In states where AmeriPath is not permitted to directly own a medical operation, it performs only non-medical administrative and support services, does not represent to the public or its clients that it offers medical services and does not exercise influence or control over the practice of medicine. In those states, AmeriPath conducts business through entities that it controls, and it is these affiliated entities that employ the physicians who practice medicine. In such states, AmeriPath generally enters into a contract that restricts the owner of the affiliated entity from transferring their ownership interests in the affiliated entity and otherwise provides the Company or its designee with a controlling voting or financial interest in the affiliated entity and its laboratory operations. This controlling financial interest generally is obtained pursuant to a long-term management service agreement between AmeriPath and the affiliated entity. Under the management services agreement, AmeriPath exclusively manages all aspects of the operation, including entering into all managed care contracts, other than the provision of medical services. Generally, the affiliated entity has no operating assets because AmeriPath acquired all of its operating assets at the time it acquired the related laboratory operations. In accordance with Emerging Issues Task Force Issue No. 97-2, Physician Practice Management Entities and Certain Other Entities with Contractual Management Agreements (EITF 97-2), Financial Accounting Standards Board (FASB) Statement No. 94 and Accounting Pronouncements Board (APB) Opinion No. 16, the financial statements of the operations AmeriPath controls, including these affiliated entities, are included in the consolidated financial statements of AmeriPath.

The Company has also acquired an interest in a few anatomic pathology laboratory operations whose financial statements are not required to be consolidated with its own under ETIF 97-2 (managed operations). In these circumstances, the Company acquired assets of physician groups and entered into service contracts with the physician groups to provide equipment, supplies, support personnel, and management and financial advisory services. The financial statements of these entities are not required to be included in the consolidated financial statements of AmeriPath since AmeriPath has no controlling interest in these operations. Management service fees received pursuant to service agreements with these operations constituted approximately 2% and 4% of the Company s net revenues for the six months ended June 30, 2006 and 2005, respectively.

Acquisitions. On January 31, 2006 we acquired Specialty Laboratories, Inc., (Specialty) a leading hospital-focused clinical reference laboratory specializing in esoteric testing in Valencia, California and on March 31, 2006 we acquired an anatomic pathology practice in Denver, Colorado. The accompanying unaudited condensed consolidated financial statements include the results of operations of the Company s acquisitions accounted for under the purchase method from the date acquired through June 30, 2006. For the first six months of 2005, the Company did not acquire any new practices. During the six months ended June 30, 2006 and 2005, we made contingent note payments of approximately $3.4 million and $8.8 million respectively, relating to previous acquisitions.

Medical Malpractice Insurance Costs. We are at risk for being sued for acts or omissions of our pathologists, our laboratory personnel or hospital employees who are under the supervision of our hospital-based pathologists. We and our pathologists periodically become involved as defendants in medical malpractice and other lawsuits, some of which are currently ongoing, and are subject to the attendant risk of substantial damage awards. In June 2002, we replaced our existing medical malpractice insurance coverage with third party insurance companies with a new self-insurance, or captive, arrangement. Under our self-insurance structure, we retain more risk for medical malpractice costs, including settlements and claims expense, than under our previous coverage. While we have obtained excess liability coverage for medical malpractice costs, we have no aggregate excess stop loss protection, meaning there is no aggregate limitation on the amount of risk we retain under these arrangements. Our medical malpractice costs are based on actuarial estimates of our medical malpractice

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settlement and claims expense and the costs of maintaining our captive insurance program and excess coverage. We periodically review and update the appropriateness of our accrued liability for medical malpractice costs. Because we retain these risks, in addition to an actual increase in claims or related expenses, a change in the actuarial assumptions upon which our medical malpractice costs are based could materially affect results of operations in a particular period, even if we do not experience an actual increase in claims or related expenses. For the six months ended June 30, 2006 and 2005, our medical malpractice cost was $7.1 million and $7.3 million, respectively. The terms of the purchase agreements relating to each of our past acquisitions generally contain certain limited rights of indemnification from the sellers of the practices. We also maintain property and general liability insurance policies and obtain indemnity agreements from third parties such as hospitals and national clinical laboratories.

Financial Statement Presentation

The following paragraphs provide a brief description of the most important items that appear in our financial statements and general factors that impact these items.

Net Revenues. Net revenues consist of revenues received from patients, third-party payors and others for services rendered. Our same store net revenue is affected by changes in customer volume, payor mix and reimbursement rates. References to same store refer to operations that have been included in our financial statements throughout the periods compared.

Cost of Services. Cost of services consists principally of the compensation and fringe benefits of pathologists, medical malpractice insurance, licensed technicians and support personnel, laboratory supplies, shipping and distribution costs and facility costs. Historically, acquisitions, and the costs associated with additional personnel and facilities, have been the most significant factor driving increases in our cost of services. Also, increases in medical malpractice insurance have affected our cost of services.

Selling, General and Administrative Expenses. Selling, general and administrative expenses primarily include the cost of field operations, corporate support, sales and marketing, information technology and billing and collections. As we have developed our national sales and marketing infrastructure, our selling, general and administrative expenses have increased. In addition, spending on new information technology initiatives historically has contributed to increased expenses in this category.

Provision for Doubtful Accounts. Provision for doubtful accounts is affected by our mix of revenue from outpatient and inpatient services. The provision for doubtful accounts typically is higher for inpatient services than for outpatient services, due primarily to a larger concentration of indigent and private pay patients, greater difficulty gathering complete and accurate billing information and longer billing and collection cycles for inpatient services. Management service revenue generally does not include a provision for doubtful accounts.

Amortization Expense. Our acquisitions have resulted in significant net identifiable intangible assets and goodwill. We record net identifiable intangible assets at fair value on the date of acquisition. Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, which required us to cease amortizing goodwill and instead perform a transitional impairment test as of January 1, 2002 and an annual impairment analysis to assess the recoverability of goodwill. The results of the transitional and annual impairment tests indicated no impairment of goodwill or other indefinite lived intangibles. We continually evaluate whether events or circumstances have occurred that may warrant revisions to the carrying values of our goodwill and other identifiable intangible assets or to the estimated useful lives assigned to such assets. Any significant impairment on the carrying values of our goodwill or other identifiable intangible assets would be recorded as a charge to income from operations and a reduction of intangible assets and could materially reduce our profitability in the period in which the charge is recorded.

Critical Accounting Policies

Our critical accounting policies remain consistent with those reported in our Annual Report on Form 10-K for the year ended December 31, 2005.

Principles of Consolidation

Our condensed consolidated financial statements include our accounts and those of our owned operations. As part of the consolidation process, we have eliminated intercompany accounts and transactions. We do not consolidate the results of operations of our managed operations.

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Segments

The Company operates in one reportable segment, the medical laboratory industry. Medical laboratories offer a broad range of testing services to the medical profession. The company s testing services are categorized based upon the nature of the test: Anatomic Pathology testing, Esoteric Services, and Dermatopathology testing. These testing services are used by physicians in the diagnosis, prognosis, monitoring and general management of diseases and other clinical conditions. The tests included in such services generally detect medically-significant abnormalities and visual patterns in blood, tissue samples and other specimens.

Results of Operations

The following table outlines, for the periods indicated, selected operating data as a percentage of net revenues.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Net revenues	100.0%	100.0%	100.0%	100.0%
Operating costs and expenses:				
Cost of services	56.3	51.7	56.5	53.3
Selling, general and administrative expenses	20.3	18.9	20.6	18.9
Provision for doubtful accounts	9.9	13.1	10.7	13.1
Amortization expense	1.5	2.4	1.9	2.4
Merger-related charges	0.6		0.5	
Total operating costs and expenses	88.6	86.1	90.2	87.7
Income from operations	11.4	13.9	9.8	12.3
Interest expense	(7.8)	(8.1)	(7.7)	(8.3)
Change in value of derivative	0.2		0.2	
Write-off of deferred financing costs			(0.9)	
Other income, net	0.3		0.2	0.1
Income before income taxes	4.1	5.8	1.6	4.1
Provision for income taxes	1.3	2.3	0.7	1.6
Net income	2.8%	3.5%	0.9%	2.5%

Net Revenues.

Net revenues increased by $48.1 million, or 33.5%, to $191.7 million for the three months ended June 30, 2006 from $143.6 million for the three months ended June 30, 2005. Net revenues increased by $85.1 million, or 30.7%, to $362.6 million for the six months ended June 30, 2006 from $277.5 million for the six months ended June 30, 2005. This increase consisted primarily of revenues of acquired practices and through growth of our same store practices. Same store net revenue increased $9.5 million or 6.7% to $150.7 million for the three months ended June 30, 2006 from $141.2 million for the three months ended June 30, 2005. Same store net revenue increased $23.6 million or 8.7% to $295.2 million for the six months ended June 30, 2006 from $271.6 million for the six months ended June 30, 2005. Net revenues include the results of Specialty from the effective date of the acquisition by the Company, which was January 31, 2006. Net revenues from Specialty for the second quarter of 2006 were $40.2 million. Net revenues from Specialty for the six-month period ended June 30, 2006 were $66.6 million.

Costs of Services.

Costs of services increased by $33.7 million, or 45.3%, to $107.9 million for the three months ended June 30, 2006 from $74.3 million for the three months ended June 30, 2005. Costs of services as a percentage of net revenues increased to 56.3% for the three months ended June 30, 2006 from 51.7% for the three months ended June 30, 2005. The increases in costs of services as a percentage of net revenues are primarily due to the acquisition of Specialty, where costs of services are approximately 10.7% higher than costs of services of the anatomic pathology business and from increased courier and distribution costs associated with the Company s increased revenues from physicians offices. For the three

months ended June 30, 2006, we continued to see a larger percentage of our net revenues generated from our outpatient practices compared to our inpatient practices. Inpatient practices generally have very low costs of services compared to outpatient practices. For the three months ended June 30, 2006 compared to the three months ended June 30, 2005, excluding Specialty, our inpatient

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revenues declined 4.6% while our outpatient revenues grew 14.1%. Costs of services for Specialty for the three months ended June 30, 2006 were $26.2 million. Gross margin decreased to 43.7% for the three months ended June 30, 2006 from 48.3% for the three months ended June 30, 2005.

Costs of services increased by $57.1 million, or 38.6%, to $204.9 million for the six months ended June 30, 2006 from $147.8 million for the six months ended June 30, 2005. Costs of services as a percentage of net revenues increased to 56.5% for the six months ended June 30, 2006 from 53.3% for the six months ended June 30, 2005. The increases in costs of services as a percentage of net revenues are primarily due to the acquisition of Specialty, where costs of services are approximately 10.7% higher than costs of services of the anatomic pathology business and from increased courier and distribution costs associated with the Company s increased revenues from physicians offices. For the six months ended June 30, 2006 compared to the six months ended June 30, 2005, excluding Specialty, our inpatient revenues declined 3.0% while our outpatient revenues grew 15.7%. Costs of services for Specialty for the three months ended June 30, 2006 were $43.4 million. Gross margin decreased to 43.5% for the six months ended June 30, 2006 from 46.7% for the six months ended June 30, 2005.

Selling, General and Administrative Expenses.

Selling, general and administrative expenses increased by $11.8 million to $39.0 million for the three months ended June 30, 2006 from $27.2 million for the three months ended June 30, 2005. As a percentage of net revenues, selling, general and administrative expenses increased to 20.3% for the three months ended June 30, 2006 from 18.9% for the three months ended June 30, 2005.

Selling, general and administrative expenses increased by $22.4 million to $74.8 million for the six months ended June 30, 2006 from $52.4 million for the six months ended June 30, 2005. As a percentage of net revenues, selling, general and administrative expenses increased to 20.6% for the six months ended June 30, 2006 from 18.9% for the six months ended June 30, 2005.

The increases in selling, general, and administrative expenses for the three and six months ended June 30, 2006 are primarily due to adding additional resources in information technology, increased sales and marketing costs, billing conversions from third-party providers, increased Sarbanes Oxley and audit related costs, adoption of SFAS 123 (R) effective January 1, 2006, and the increase from Specialty s selling, general, and administrative costs, which are higher than historical selling, general, and administrative costs of the anatomic pathology business. Selling, general, and administrative expenses from Specialty for the second quarter of 2006 were $9.6 million. Selling, general, and administrative expenses from Specialty for the six month period ended June 30, 2006 were $15.4 million.

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Provision for Doubtful Accounts.

Our provision for doubtful accounts increased by $0.2 million to $19.0 million for the three months ended June 30, 2006 from $18.8 million for the same period of 2005. The provision for doubtful accounts as a percentage of net revenues decreased to 9.9% for the three months ended June 30, 2006 from 13.1% for the same period of 2005.

Our provision for doubtful accounts increased by $2.4 million to $38.8 million for the six months ended June 30, 2006 from $36.4 million for the same period of 2005. The provision for doubtful accounts as a percentage of net revenues decreased to 10.7% for the six months ended June 30, 2006 from 13.1% for the same period of 2005.

Outpatient and esoteric revenues, as a percentage of total revenues, continued to grow at a faster rate than our inpatient revenues. The bad debt percentages on outpatient and esoteric revenues are generally lower than on inpatient revenues and therefore reduces total bad debt expense as a percentage of total revenues. Outpatient and esoteric revenues, as a percentage of total revenues, for the three months ended June 30, 2006 were 73.2% compared to 45.4% for the three months ended June 30, 2005. Outpatient and esoteric revenues, as a percentage of total revenues, for the six months ended June 30, 2006 were 71.6% compared to 61.0% for the six months ended June 30, 2005. The provision for doubtful accounts from Specialty for the second quarter of 2006 was $0.9 million. The provision for doubtful accounts from Specialty for the six month period ended June 30, 2006 was $1.7 million.

Amortization Expense.

Amortization expense decreased by $0.6 million, to $2.9 million for the three months ended June 30, 2006 from $3.5 million for the three months ended June 30, 2005.

Amortization expense remained constant at $6.8 million for the six months ended both June 30, 2006 and 2005.

Merger Costs

For the three months ended June 30, 2006, in connection with the acquisition of Specialty, the Company incurred $1.2 million in merger costs.

For the six months ended June 30, 2006, in connection with the acquisition of Specialty, the Company incurred $1.8 million in merger costs.

Gain on Sale of Managed Practice.

In February 2005, the Company sold a managed practice in Los Gatos, California resulting in a gain of approximately $0.5 million**.**

Interest Expense.

Interest expense increased by $3.2 million to $14.9 million for the three months ended June 30, 2006 from $11.7 million for the same period of 2005. Our effective interest rate was 9.4% and 9.5% for the three months ended June 30, 2006 and 2005, respectively.

Interest expense increased by $5.1 million to $28.0 million for the six months ended June 30, 2006 from $22.9 million for the six months ended June 30, 2005. Our effective interest rate was 9.7% and 9.3% for the six months ended June 30, 2006 and 2005, respectively.

Write-off of Deferred Financing Costs.

In January 2006, in connection with the acquisition of Specialty, the Company terminated its existing credit facility and entered into a new senior credit facility. As a result of terminating the credit facility, the Company wrote-off approximately $3.4 million of its deferred debt financing costs.

In April 2005, the Company wrote-off approximately $0.2 million of its deferred debt financing costs as a result of a $6.3 million voluntary prepayment of the term loan facility. In June 2005, the Company wrote-off approximately $0.1 million of its deferred debt financing costs as a result of a $5.0 million voluntary prepayment of the term loan facility.

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Change in Value of Derivative.

In April 2004, the Company entered into a 2 1/2 year interest rate swap transaction with a notional amount of $75.0 million. The market valuation is performed quarterly by an independent third party and the change in market value of the derivative instrument is recognized in the condensed consolidated statements of income. For the six months ended June 30, 2006, the Company recognized a $0.7 million gain in the value of the derivative. For the six months ended June 30, 2005, the Company recognized a $0.3 million loss in the value of the derivative.

Provision for Income Taxes.

Our effective income tax rate was 47.4% and 39.8% for the six month periods ended June 30, 2006 and 2005, respectively. The increase in tax rate is a result of an increase in the state income tax valuation allowance and non-deductible merger costs in connection with the acquisition of Specialty.

Net Income.

Net income for the three months ended June 30, 2006, was $5.2 million compared with net income of $5.1 million for the same period of 2005.

Net income for the six months ended June 30, 2006, was $3.1 million compared with net income of $6.8 million for the six months ended June 30, 2005.

Liquidity and Capital Resources

At June 30, 2006, we had working capital of approximately $94.9 million, an increase of $31.2 million from working capital of $63.7 million at December 31, 2005. The acquisition of Specialty was the primary reason for the increase in working capital for the six months ended June 30, 2006.

Net cash provided by operating activities was $1.9 million and $12.5 million for the six months ended June 30, 2006 and 2005, respectively. The decrease in cash provided by operations from the six months ended June 30, 2005 to the six months ended June 30, 2006 was primarily caused by an increase in net accounts receivable and an increase in cash outflows to pay down accounts payable which was offset by an increase in depreciation and amortization.

Net cash used in investing activities increased $175.9 million from $20.5 million for the six months ended June 30, 2005 to $196.4 for the six months ended June 30, 2006. The increase in cash used in investing activities from the six months ended June 30, 2005 to the six months ended June 30, 2006 was primarily caused by cash paid for the Specialty acquisition of $168.7 million and an increase in acquisitions of property, plant and equipment from $14.0 million for the six months ended June 30, 2005 to $24.0 million for the six months ended June 30, 2006. These increases were partially offset by decreased contingent notes payments in the six months ended June 30, 2006 compared to the same period in the previous year.

Net cash provided by financing activities increased $200.2 million from $(1.4) million for the six months ended June 30, 2005 to $198.8 million for the six months ended June 30, 2006. The increase in cash provided by financing activities from the six months ended June 30, 2005 to the six months ended June 30, 2006 relates to increased levels of debt under our new credit facility to fund the Specialty acquisition, an equity investment by our parent to help fund the Specialty acquisition, and a release of funds from our contingent note reserve to pay contingent notes and help fund the Specialty acquisition.

On January 31, 2006, in connection with the merger of Specialty, the Company terminated its existing senior credit facility and the Company entered into a new senior credit facility (the New Credit Facility) with a syndicate of financial institutions led by Wachovia Bank and Citigroup Global Markets, Inc. The new senior credit facility consists of a $203.5 million term loan and a $95.0 million revolving credit facility. The Company borrowed $203.5 million of the term loan and $52.0 million of the revolving credit facility to fund a portion of the Specialty merger consideration, to pay certain transaction costs related to the merger, to refinance existing indebtedness of the Company and to pay related expenses with the merger.

The interest rates per annum applicable to loans under the New Credit Facility are, at the Company s option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period chosen by the Company, or a nine or twelve month period if agreed to by all participating lenders, plus an applicable margin percentage in each case.

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The alternate base rate is the greater of (1) the prime rate or (2) one-half of 1% over the weighted average of rates on overnight federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate will be determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The facility also requires a commitment fee to be paid quarterly equal to 0.125% of any unused commitments under the revolving loan facility.

On March 27, 2003, in connection with the March 2003 Transaction, Amy Acquisition Corp. issued $275.0 million of 10 1/2% Senior Subordinated Notes due 2013. We assumed Amy Acquisition Corp. s obligations under these notes upon consummation of the March 2003 Transaction. Interest became payable semi-annually in arrears beginning in October 2003. In February 2004, we issued an additional $75.0 million of our 10 1/2% Senior Subordinated Notes due 2013 at a premium price of 106%. The notes are unconditionally guaranteed, jointly and severally and on an unsecured senior subordinated basis, by certain of our current and former subsidiaries. The notes and guarantees rank junior to all of our and the guarantors existing and future senior indebtedness, on par with all of our and the guarantors existing and future senior subordinated indebtedness and senior to all of our and the guarantors existing and future subordinated indebtedness. We may redeem any of the notes at any time and from time to time beginning on April 1, 2008, in whole or in part, in cash at the specified redemption prices, plus accrued and unpaid interest to the date of redemption.

The Credit Facility and the indenture governing the notes contain covenants that, among other things, limit our ability and the ability of our restricted subsidiaries to incur or guarantee additional indebtedness, pay dividends or make other equity distributions, purchase or redeem capital stock, make certain investments, transfer and sell assets, engage in certain transactions with affiliates and effect a consolidation or merger.

Historically, our capital expenditures have been primarily for laboratory equipment, information technology equipment and leasehold improvements. Total capital expenditures were $24.0 million and $14.0 million for the six months ended June 30, 2006 and 2005, respectively.

We expect to use our revolving loan facility and operating cash flow to fund internal growth, for acquisitions and for working capital. We anticipate that funds generated by operations, funds available under our revolving loan facility and funds in the cash collateral account will be sufficient to meet working capital requirements and anticipated contingent note obligations and to finance capital expenditures over the next twelve months. Further, in the event payments under the contingent payment obligations exceed the amounts held in the cash collateral account, we believe that the incremental cash generated from operations would exceed the cash required to satisfy those additional payments.

Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements as of June 30, 2006.

Contractual Obligations

The following is a summary of our contractual cash obligations, excluding interest and payments on our contingent notes, as of June 30, 2006, for our term loan, our revolver loan, senior subordinated notes, and other indebtness, and as of December 31, 2005 for our operating leases. The balances of our operating leases, with the exception of adding Specialty s lease balance as of December 31, 2005, which is included in the schedule hereon, have not changed substantially since year end.

	Payments Due By Period (in millions)				
Contractual Obligations [1]	**Less than 1 year**	**1-2 years**	**3-5 years**	**After 5 years**	**Total**
Term loan under our senior credit facility	$ 2.0	$ 2.0	$ 6.1	$ 192.9	$ 203.0
Revolver loan			69.0		69.0
Other indebtedness	0.1	0.1			0.2
Operating leases	11.4	10.6	27.7	86.7	136.4
Senior subordinated notes				350.0	350.0
Total contractual cash obligations	$ 13.5	$ 12.7	$ 102.8	$ 629.6	$ 758.6

(1) In addition, we have issued contingent notes in connection with our previous acquisitions that are structured to provide for payments to sellers upon the achievement of specified levels of operating income by the acquired operations over three to five year periods from the

date of acquisition. As of June 30, 2006, our maximum obligation remaining under the contingent notes was $5.3 million.

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Interest Rate Risk

The Company is subject to market risk associated principally with changes in interest rates. Our principal interest rate exposure relates to the amount outstanding under the Company s credit facility. The balances outstanding under the credit facility are at floating rates. Based on the outstanding balance of $272.0 million at June 30, 2006, each quarter point increase or decrease in the floating rate increases or decreases interest expense by approximately $0.6 million per year.

In April 2004, the Company entered into a 2 1/2 year interest rate swap transaction which involves the exchange of fixed for floating rate interest payments without the exchange of the underlying principal amount. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense. The change in the market value of the derivative instrument is recognized in the consolidated statements of income. For the six months ended June 30, 2006 and 2005, the change in the value of the derivative was a gain of approximately $0.7 million and a loss of approximately $0.3 million respectively, which is reflected in the accompanying consolidated statements of income.

Inflation

Inflation was not a material factor in either revenues or operating expenses during the first six months of 2006.

Qualification of Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements contained anywhere in this Quarterly Report on Form 10-Q that are not limited to historical information are considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions, plans or strategies regarding the future. These forward-looking statements are based largely on our expectations which are subject to a number of known and unknown risks, uncertainties and other factors discussed in this report and in other documents filed by us with the SEC, which may cause actual results to be materially different from those anticipated, expressed or implied by the forward-looking statements. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements to reflect future events or circumstances. Forward-looking statements are sometimes indicated by words such as may, should, believe, expect, anticipate and similar expressions.

In addition to the risks and uncertainties identified elsewhere herein and in other documents filed by us with the SEC, the matters discussed below under the heading Risk Factors should be carefully considered when evaluating our business and future prospects. Past performance is not necessarily indicative of future results.

RISK FACTORS

The risks described below are not the only ones facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially and adversely affect our business, financial condition or results of operations. Any of the following risks could materially and adversely affect our business, financial condition or results of operations.

We may not successfully integrate the acquisition of Specialty with AmeriPath and may be unable to achieve anticipated cost savings and other synergies.

The integration of Specialty s operations following the consummation of the merger involves a number of risks and presents financial, managerial and operational challenges. In particular, we may have difficulty, and may incur unanticipated expenses related to, integrating management and personnel from Specialty with AmeriPath s management and personnel. Additionally, we may not be able to achieve the anticipated cost savings or other synergies. Failure to integrate the acquisition of Specialty successfully may have a material adverse effect on our business, results of operations, financial condition and cash flow.

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Our substantial indebtedness could adversely affect our financial condition and prevent us from fulfilling our obligations under our term loan and subordinated debt.

We have a significant amount of indebtedness. As of June 30, 2006, our total debt was $622.2 million, excluding unused revolving loan commitments under our senior credit facility, which represented approximately 52% of our total capitalization. This debt does not include $5.3 million of obligations under our contingent notes.

Our substantial indebtedness could have important consequences by adversely affecting our financial condition and thus making it more difficult for us to satisfy our obligations. Our substantial indebtedness could:

- increase our vulnerability to adverse general economic and industry conditions,
- require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures, payments under our contingent notes, research and development efforts and other general corporate purposes,
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate,
- place us at a competitive disadvantage compared to our competitors that have less debt and
- limit our ability to borrow additional funds.

Despite our level of indebtedness, we may be able to incur substantially more debt. This could further exacerbate the risks to our financial condition described above.

We may be able to incur significant additional indebtedness in the future. Although the indenture governing the notes and the credit agreement governing our senior credit facility contain restrictions on the incurrence of additional indebtedness, these restrictions are subject to a number of qualifications and exceptions and the indebtedness incurred in compliance with these restrictions could be substantial. Moreover, the restrictions also do not prevent us from incurring obligations that do not constitute indebtedness. To the extent new debt is added to our currently anticipated debt levels, the substantial leverage risks described above would increase.

The terms of our senior credit facility and the indenture relating to our notes may restrict our current and future operations, particularly our ability to respond to changes or to take certain actions.

Our senior credit facility contains a number of restrictive covenants that impose significant operating and financial restrictions on us and may limit our ability to engage in acts that may be in our long-term best interests. Our senior credit facility includes covenants restricting, among other things, our ability to:

- incur additional debt,
- pay dividends and make restricted payments,
- create liens,

use the proceeds from sales of assets and subsidiary stock,

enter into sale and leaseback transactions,

make capital expenditures,

change our business,

enter into transactions with affiliates and

transfer all or substantially all of our assets or enter into merger or consolidation transactions.

The indenture relating to the notes also contains numerous operating and financial covenants including, among other things, restrictions on our ability to:

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incur additional debt,

pay dividends or purchase our capital stock,

make investments,

enter into transactions with affiliates,

sell or otherwise dispose of assets and

merge or consolidate with another entity.

Our senior credit facility also includes financial covenants, including requirements that we maintain:

a minimum interest coverage ratio,

a minimum fixed charge coverage ratio and

a maximum senior leverage ratio.

These financial covenants will become more restrictive over time.

A failure by us to comply with the covenants contained in our senior credit facility or the indenture could result in an event of default. In the event of any default under our senior credit facility, the lenders under our senior credit facility could elect to declare all borrowings outstanding, together with accrued and unpaid interest and fees, to be due and payable, enforce their security interest, require us to apply all of our available cash to repay these borrowings (even if the lenders have not declared a default) or prevent us from making debt service payments on the notes, any of which would result in an event of default under the notes. In addition, future indebtedness could contain financial and other covenants more restrictive than those applicable to our senior credit facility and the notes.

We may not be able to generate sufficient cash flow to meet our debt service obligations.

Our cash flow from operations declined $10.6 million from $12.5 million for the six months ended June 30, 2005 to $1.9 million for the six months ended June 30, 2006. Our ability to generate sufficient cash flow from operations to make scheduled payments on our debt obligations will depend on our future financial performance, which will be affected by a range of economic, competitive, regulatory, legislative and business factors, many of which are outside of our control. If we do not generate sufficient cash flow from operations to satisfy our debt obligations, including payments on the notes, we may have to undertake alternative financing plans, such as refinancing or restructuring our debt, selling assets, reducing or delaying capital investments or seeking to raise additional capital. We cannot assure you that any refinancing would be possible or that any assets could be sold on acceptable terms or otherwise. Our inability to generate sufficient cash flow to satisfy our debt obligations, or to refinance our obligations on commercially reasonable terms, would have an adverse effect on our business, financial condition and results of operations, as well as on our ability to satisfy our obligations under the notes.

We conduct business in a heavily regulated industry, and changes in regulations or violations of regulations may, directly or indirectly, reduce our revenues and harm our business.

The healthcare industry is highly regulated, and there can be no assurance that the regulatory environment in which we operate will not change significantly and adversely in the future. Several areas of regulatory compliance that may affect our ability to conduct business include:

federal and state anti-kickback laws,

federal and state self-referral and financial inducement laws, including the federal physician anti-self-referral law, or the Stark Law,

federal and state false claims laws,

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state laws regarding prohibitions on the corporate practice of medicine,

state laws regarding prohibitions on fee-splitting,

federal and state anti-trust laws,

the Health Insurance Portability and Accountability Act of 1996, or HIPAA,

federal and state regulation of privacy, security and electronic transactions and code sets and

federal, state and local laws governing the handling and disposal of medical and hazardous waste.

These laws and regulations are extremely complex. In many instances, the industry does not have the benefit of significant regulatory or judicial interpretation of these laws and regulations. It also is possible that the courts could ultimately interpret these laws in a manner that is different from our interpretations. While we believe that we are currently in material compliance with applicable laws and regulations, a determination that we have violated these laws, or the public announcement that we are being investigated for possible violations of these laws, would have an adverse effect on our business, financial condition and results of operations. For a more complete description of these regulations, see Business Government Regulation in our Form 10-K for the year ended December 31, 2005.

Our business could be materially harmed by future interpretation or implementation of state laws regarding prohibitions on the corporate practice of medicine.

The manner in which licensed physicians can be organized to perform and bill for medical services is governed by state laws and regulations. Under the laws of some states, business corporations generally are not permitted to employ physicians or to own corporations that employ physicians or to otherwise exercise control over the medical judgments or decisions of physicians.

We believe that we currently are in compliance with the corporate practice of medicine laws in the states in which we operate in all material respects. Nevertheless, there can be no assurance that regulatory authorities or other parties will not assert that we are engaged in the corporate practice of medicine or that the laws of a particular state will not change. If such a claim were successfully asserted in any jurisdiction, or as a result of such a change in law, we could be required to restructure our contractual and other arrangements, our Company and our pathologists could be subject to civil and criminal penalties and some of our existing contracts, including non-competition provisions, could be found to be illegal and unenforceable. In addition, expansion of our operations to other states may require structural and organizational modification of our form of relationship with pathologists, operations or hospitals. These results or the inability to successfully restructure contractual arrangements would have an adverse effect on our business, financial condition and results of operations.

We could be hurt by future interpretation or implementation of federal and state anti-kickback and anti-referral laws.

Federal and state anti-kickback laws prohibit the offer, solicitation, payment and receipt of remuneration in exchange for referrals of products and services for which payment may be made by Medicare, Medicaid or other federal and state healthcare programs. Federal and state anti-referral laws, including the Stark Law, prohibit physicians from referring their patients to healthcare providers with whom the physicians or their immediate family members have a financial relationship for designated services when such services are subject to reimbursement by Medicare or Medicaid. A violation of any of these laws could result in monetary fines, civil and criminal penalties and exclusion from participation in Medicare, Medicaid and other federal and state healthcare programs, which accounted for approximately 22% of our revenues during the first six months of 2006.

We owe some of our physicians contingent payment obligations entered into in connection with acquisitions we have completed and some of our physicians are a party to compensation arrangements with us and own common stock of our parent. Although we have attempted to structure our businesses so that our financial relationships with our physicians and our referral practices comply in all material respects with federal and state anti-referral laws, including the Stark Law, the government may take the position that they do not comply, or a prohibited referral may be made by one of our physicians without our knowledge. If our financial relationships with our physicians were found to be unlawful or unlawful referrals were found to have been made, we or they could be fined, become subject to government recoupment of fees previously paid to us and

forfeiture of revenues due to us or become subject to civil and criminal penalties. In such situations, we also may be excluded from participation in Medicare, Medicaid and other federal and state healthcare programs. Any one of these consequences could have an adverse effect on our business, financial condition and results of operations.

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Our business could be harmed by future interpretation or implementation of state law prohibitions on fee-splitting.

Many states prohibit the splitting or sharing of fees between physicians and non-physicians. We believe our arrangements with pathologists and operations comply in all material respects with the fee-splitting laws of the states in which we operate. Nevertheless, it is possible that regulatory authorities or other parties could claim we are engaged in fee-splitting. If such a claim were successfully asserted in any jurisdiction, our pathologists could be subject to civil and criminal penalties, including loss of licensure, and we could be required to restructure our contractual and other arrangements. In addition, expansion of our operations to new states with fee-splitting prohibitions may require structural and organizational modification to the form of our current relationships which may be less profitable. A claim of fee-splitting or modification of our business to avoid such a claim could have an adverse effect on our business, financial condition and results of operations.

Federal and state regulation of privacy could cause us to incur significant costs.

The Federal Trade Commission, or FTC, pursuant to consumer protection laws, and the Department of Health and Human Services, or HHS, pursuant to HIPAA, regulate the use and disclosure of information we may have about our patients. Many states also have laws regarding privacy of health information. While we believe that we are in compliance with FTC and state laws regarding privacy, and with the HIPAA privacy regulations, these laws are complex and will have an impact upon our operations. Violations of the HIPAA privacy regulations are punishable by civil and criminal penalties. In addition, while individuals do not have a private right of action under HIPAA, the privacy regulations may be viewed by the courts as setting a standard of conduct, and the failure to comply could serve as the basis for a private claim. In addition, HIPAA regulations regarding the security of health information and standards for electronic transactions have also been issued. While many of our systems have already been configured to comply with these regulations, to achieve compliance we may need to modify or replace systems in certain of our locations and incur related expenses.

We are subject to significant professional or other liability claims and we cannot assure you that insurance coverage will be available or sufficient to cover such claims.

We may be sued under physician liability or other liability law for acts or omissions by our pathologists, laboratory personnel and hospital employees who are under the supervision of our hospital-based pathologists. We and our pathologists periodically become involved as defendants in medical malpractice and other lawsuits, some of which are currently ongoing, and are subject to the attendant risk of substantial damage awards.

Through June 30, 2002, we were insured for medical malpractice risks on a claims made basis under traditional professional liability insurance policies. In July 2002, we began using a captive insurance program to partially self-insure our medical malpractice risk. Under the captive insurance program we retain more risk for medical malpractice costs, including settlements and claims expenses, than under our prior coverage. We have no aggregate excess stop loss protection under our captive insurance arrangements, meaning there is no aggregate limitation on the amount of risk we retain under these arrangements. Because of our self-insurance arrangements and our lack of aggregate excess stop loss protection, professional malpractice claims could result in substantial uninsured losses. In addition, it is possible that the costs of our captive insurance arrangements and excess insurance coverage will rise, causing us either to incur additional costs or to further limit the amount of our coverage. Further, our insurance does not cover all potential liabilities arising from governmental fines and penalties, indemnification agreements and certain other uninsurable losses. For example, from time to time we agree to indemnify third parties, such as hospitals and national clinical laboratories, for various claims that may not be covered by insurance. As a result, we may become responsible for substantial damage awards that are uninsured. We are currently subject to indemnity claims, which if determined adversely to us, could result in substantial uninsured losses. Therefore, it is possible that pending or future claims will not be covered by or will exceed the limits of our insurance coverage and indemnification agreements or that third parties will fail or otherwise be unable to comply with their obligations to us.

Government programs account for approximately 22% of our revenues, so a decline in reimbursement rates from government programs would harm our revenues and profitability.

We derived approximately 22% of our net revenues during the first six months of 2006 from payments made by government programs, principally Medicare and Medicaid. These programs are subject to substantial regulation by federal and state governments. Any changes in reimbursement policies, practices, interpretations or statutes that place limitations on

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reimbursement amounts or change reimbursement coding practices could materially harm our business by reducing revenues and lowering profitability. Increasing budgetary pressures at both the federal and state levels and concerns over escalating costs of healthcare have led, and may continue to lead, to significant reductions in healthcare reimbursements, which would have an adverse effect on our business, financial condition and results of operations.

We incur financial risk related to collections as well as potentially long collection cycles when seeking reimbursement from third-party payors.

Substantially all of our net revenues are derived from services for which our operations charge on a fee-for-service basis. Accordingly, we assume the financial risk related to collection, including potential write-offs of doubtful accounts, and long collection cycles for accounts receivable, including reimbursements by third-party payors, such as governmental programs, private insurance plans and managed care organizations. Our provision for doubtful accounts for the three months ended June 30, 2006 was 9.9% of net revenues, with net revenues from inpatient services having a provision for doubtful accounts of approximately 24.3%. If our revenue from hospital-based services increases as a percentage of our total net revenues, our provision for doubtful accounts as a percentage of total net revenues may increase. Increases in write-offs of doubtful accounts, delays in receiving payments or potential retroactive adjustments and penalties resulting from audits by payors could have an adverse effect on our business, financial condition and results of operations.

In addition to services billed on a fee-for-service basis, our hospital-based pathologists in their capacities as medical directors of hospitals clinical laboratories, microbiology laboratories and blood banking operations, bill non-Medicare patients according to a fee schedule for their clinical professional component, or CPC, services. Our historical collection experience for CPC services is significantly lower than other anatomic pathology procedures. See Business-Billing. Hospitals and third party payors are continuing to increase pressure to reduce our revenues from CPC services, including but not limited to encouraging their patients not to pay us for such services.

The continued growth of managed care may have a material adverse effect on our business.

The number of individuals covered under managed care contracts or other similar arrangements has grown over the past several years and may continue to grow in the future. In addition, Medicare and Medicaid and other government healthcare programs may continue to shift to managed care. For the six month periods ended June 30, 2006 and 2005, approximately 54%, and 55%, respectively, of our net revenue was derived from reimbursements from managed care organizations and third party payors. Entities providing managed care coverage have reduced payments for medical services in numerous ways, including entering into arrangements under which payments to a service provider are capitated, limiting testing to specified procedures, denying payment for services performed without prior authorization and refusing to increase fees for specified services. These trends reduce our revenues and limit our ability to pass cost increases to our customers. Also, if these or other managed care organizations do not select us as a participating provider, we may lose some or all of that business, which could have an adverse effect on our business, financial condition and results of operations.

There has been an increasing number of state and federal investigations of healthcare companies, which may increase the likelihood of investigations of our business practices and the possibility that we will become subject to lawsuits.

Prosecution of fraudulent practices by healthcare companies is a priority of the United States Department of Justice, HHS s Office of the Inspector General, or OIG, and state authorities. The federal government has become more aggressive in examining laboratory billing practices and seeking repayments and penalties allegedly resulting from improper billing practices, such as using an improper billing code for a test to realize higher reimbursement. While the primary focus of this initiative has been on hospital laboratories and on routine clinical chemistry tests, which comprise only a small portion of our revenues, the scope of this initiative could expand, and it is not possible to predict whether or in what direction the expansion might occur. In certain circumstances, federal and some state laws authorize private whistleblowers to bring false claim or qui tam suits against providers on behalf of the government and reward the whistleblower with a portion of any final recovery. In addition, the federal government has engaged a number of non-governmental audit organizations to assist in tracking and recovering false claims for healthcare services.

Since investigations relating to false claims have increased in recent years, it is more likely that companies in the healthcare industry, like us, could become the subject of a federal or state civil or criminal investigation or action. While we believe that we are in compliance in all material respects with federal and state fraud and abuse statutes and regulations, and we monitor our billing practices and hospital arrangements for compliance with prevailing industry practices under applicable laws, these laws are complex and constantly evolving, and it is possible that governmental investigators may take positions that are inconsistent with our practices. Moreover, even when the results of an investigation or a qui tam suit are favorable to a company, the process is time consuming and legal fees and diversion of company management focus are expensive. Any lengthy investigation could have an adverse effect on our business, financial condition and results of operations.

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Investigations of entities with which we do business and regulatory audits could adversely affect us.

HCA Inc., or HCA, has been under investigation with respect to fraud and abuse issues. As of June 30, 2006, we provided medical director services for 27 HCA hospital laboratories. As a result, the government s investigation of HCA could result in investigations of one or more of our operations. Furthermore, we have received subpoenas from the United States Attorney s office in Tampa, Florida to deliver Medicare billing records and other documents relating to alleged financial inducements received by a Florida physician who is not a pathologist with our Company but was one of our clients. In addition, certain of our affiliates received subpoenas from the Florida Attorney General Medicaid Fraud Control Unit requesting copies of agreements that we have with certain hospitals and certain patient records. To our knowledge, numerous other hospitals and facilities have received similar subpoenas, which may indicate a state-wide audit of pathology operations. Specialty Laboratories, Inc., a California corporation received a subpoena from the California Attorney General s Office. The subpoena seeks various documents including documents relating to billings to the Medicaid program with time frames ranging from three to ten years. We are providing or have provided information to the United States Attorney s Office, the Florida Attorney General s Office and California Attorney General s Office and intend to cooperate in the investigations. It is not possible at this point in the investigation to determine whether the government will pursue action against us or to assess the merits of possible defenses we may have to any such action. Accordingly, no assurances can be given regarding the ultimate outcome of the investigations.

We derive a significant portion of our revenues from short-term hospital contracts and hospital relationships that can be terminated without penalty.

Many of our hospital contracts may be terminated prior to the expiration of the initial or any renewal term by either party with relatively short notice and without cause. We also have business relationships with hospitals that are not governed by written contracts and may be terminated by the hospitals at any time. Loss of a hospital contract or relationship would not only result in a loss of net revenues but may also result in a loss of the outpatient net revenues derived from our association with the hospital and its medical staff. Any such loss could also result in an impairment of the balance sheet value of the assets we have acquired or may acquire, requiring substantial charges to earnings. Continuing consolidation in the hospital industry resulting in fewer hospitals and fewer laboratories enhances the risk that some of our hospital contracts and relationships may be terminated, which could have an adverse effect on our business, financial condition and results of operations.

If we cannot effectively implement our internal growth strategy, it would materially and adversely affect our business and results of operations.

Our focus on internal growth, which is based upon our existing relationships and services offered, is a departure from our prior focus on growth through acquisitions. The success of our strategy rests upon increasing testing volumes, improving the mix of our services and obtaining more favorable pricing, all of which will result in a greater focus on our sales and marketing function. The success of this strategy also is dependent upon our ability to hire and retain qualified personnel, including pathologists, to develop new areas of expertise and new customer relationships and to expand our current relationships with existing customers. There can be no assurance that we will be able to make our new strategy a success.

We may inherit significant liabilities from operations that we have acquired or acquire in the future.

We perform due diligence investigations with respect to potential liabilities of acquired operations and typically obtain indemnification from the sellers of such operations. Nevertheless, undiscovered claims may arise, and liabilities for which we become responsible may be material and may exceed either the limitations of any applicable indemnification provisions or the financial resources of the indemnifying parties. Claims or liabilities of acquired operations may include matters involving compliance with laws, including healthcare laws. While we believe, based on our due diligence investigations, that our acquired operations were generally in compliance with applicable healthcare laws prior to their acquisition, they may not have been in full compliance and we may become accountable for their non-compliance. A violation of the healthcare laws could result in monetary fines, government recoupment of fees previously paid to us, forfeiture of revenues due to us or civil and criminal penalties. In such situations, we may also be excluded from participation in Medicare, Medicaid and other federal and state healthcare programs. Any one of these consequences could have an adverse effect on our business, financial condition and results of operations.

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We have significant contingent liabilities payable to many of the sellers of operations that we have acquired.

In connection with our past acquisitions, we typically have agreed to pay the sellers additional consideration in the form of contingent note obligations. Payment on these contingent notes typically depends upon the financial performance of the acquired operation or the retention of specified hospital contracts over periods ranging from three to five years after the acquisition. The amount of these contingent note payments cannot be determined until the contingency periods terminate and the level of the performance is ascertainable. As of June 30, 2006, if the minimum performance that would result in the maximum amount being payable for existing contingent notes were achieved, we would be obligated to make principal payments of approximately $5.3 million over the next two years. Lesser amounts would be paid if the maximum criteria are not met. Although we believe we will be able to make payments on contingent note obligations existing prior to the March 2003 Transaction from the remaining balance in the cash collateral account held by our parent, it is possible that such payments, or payments on additional contingent notes issued as part of subsequent acquisitions, could cause significant liquidity problems for us.

We have recorded a significant amount of intangible assets, which may never generate the returns we expect.

Our acquisitions have resulted in significant increases in net identifiable intangible assets and goodwill. Net identifiable intangible assets, which include hospital contracts, management service agreements and laboratory contracts acquired in acquisitions, were approximately $214.4 million at June 30, 2006, representing approximately 15.6% of our total assets. Goodwill, which relates to the excess of cost over the fair value of the net assets of the businesses acquired, was approximately $842.0 million June 30, 2006, representing approximately 61.4% of our total assets. Goodwill and net identifiable intangible assets are recorded at fair value on the date of acquisition and, under Financial Accounting Standards Board Statement No. 142, will be reviewed at least annually for impairment. Impairment may result from, among other things, deterioration in performance of the acquired company, adverse market conditions, adverse changes in applicable laws or regulations, including changes that restrict the activities of the acquired business, and a variety of other circumstances. The amount of any impairment must be written off. We evaluated our recorded goodwill and identifiable intangible assets during December 2005 and determined that there was no asset impairment charge required with respect to our intangible assets. We may not ever realize the full value of our intangible assets. Any future determination requiring the write-off of a significant portion of intangible assets would have an adverse effect on our financial condition and results of operations.

Our business is highly dependent on the recruitment and retention of qualified pathologists.

Our business is dependent upon recruiting and retaining pathologists, particularly those with subspecialties, such as dermatopathology, hematopathology, immunopathology and cytopathology. While we have been able to recruit and retain pathologists in the past, we may be unable to continue to do so in the future as competition for the services of pathologists increases. In addition, we may need to provide more compensation to our pathologists in order to enhance our recruitment and retention efforts and may be unable to recover these increased costs through price increases. The relationship between the pathologists and their respective local medical communities is important to the operation and continued profitability of each of our local operations. Loss of even one of our pathologists could lead to the loss of hospital contracts or other sources of revenue derived from our relationship with the pathologist. For the years ended 2005, 2004 and 2003, turnover rates for our pathologists were 9.0%, 8.1%, and 13.3%, respectively. If turnover rates were to increase, our revenues and earnings could be adversely affected.

We may be unable to enforce non-competition provisions with departed pathologists.

We either directly employ our pathologists or control a physician-owned entity that employs our pathologists. Each of our pathologists typically enters into an employment agreement with us or a company we control. Most of these employment agreements prohibit the pathologist from competing with our company within a defined geographic area and prohibit solicitation of other pathologists, employees or clients for a period of one to two years after termination of employment. We attempt to structure all of these contracts in accordance with applicable laws and to maintain and enforce these contracts as necessary. However, agreements not to compete are subject to many limitations under state law and these limitations may vary from state to state. We cannot predict whether a court will enforce the non-competition covenants in our various employment agreements. A finding that these covenants are unenforceable could have an adverse effect on our business, financial condition and results of operations.

Competition from other providers of pathology services may materially harm our business.

We have numerous competitors, including anatomic pathology practices, large physician group practices, hospital laboratories, specialized commercial laboratories and the anatomic pathology divisions of some national clinical laboratories. Moreover, companies in other healthcare segments, some of which have previously been customers of ours, such as hospitals,

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national clinical laboratories, managed care organizations and other third-party payors, may enter our markets and begin to compete with us. For example, Quest Diagnostics, Incorporated, or Quest, a national clinical laboratory company and former customer of ours, has begun to compete with us in some markets. Some of our competitors may have greater financial resources than us, which could further intensify competition. Increasing competition may erode our customer base, reduce our sources of revenue, cause us to reduce prices, enter into more capitated contracts in which we take on greater pricing risks or increase our marketing and other costs of doing business. Increasing competition may also impede our growth objectives by making it more difficult or more expensive for us to acquire or affiliate with additional pathology operations.

We depend on numerous complex information systems, and any failure to successfully maintain those systems or implement new systems could materially harm our operations.

We depend upon numerous information systems for operational and financial information, test reporting for our physicians and our complex billing operations. We currently have several major information technology initiatives underway, including the integration of information from our operations. No assurance can be given that we will be able to enhance existing or implement new information systems that can integrate successfully our disparate operational and financial information systems. In addition to their integral role in helping our operations realize efficiencies, these new systems are critical to developing and implementing a comprehensive enterprise-wide management information database. To develop an integrated network, we must continue to invest in and administer sophisticated management information systems. We may experience unanticipated delays, complications and expenses in implementing, integrating and operating our systems. Furthermore, our information systems may require modifications, improvements or replacements as we expand and as new technologies become available. These modifications, improvements or replacements may require substantial expenditures and may require interruptions in operations during periods of implementation. Moreover, implementation of these systems is subject to the availability of information technology and skilled personnel to assist us in creating and implementing the systems. The failure to successfully implement and maintain operation, financial, test reports, billing and physician practice information systems would have an adverse effect on our business, financial condition and results of operations.

Failure to timely or accurately bill for our services may have a substantial negative impact on our revenues, cash flow and bad debt expense.

Billing for laboratory testing services involves numerous parties and complex issues and procedures. The industry practice is to perform tests in advance of payment and without certainty as to the outcome of the billing process. We bill various payors, such as patients, government programs, physicians, hospitals and managed care organizations. These various payors have different billing information requirements and typically reimburse us only for medically necessary tests and only after we comply with a variety of procedures, such as providing them with Current Procedural Terminology, or CPT, codes and other information. If we do not meet all of the payors stringent requirements, we may not be reimbursed, which would increase our bad debt expense.

Among many other factors complicating our billing are:

- disputes between payors as to which party is responsible for payment,
- disparity in coverage among various payors, and
- difficulty satisfying the specific compliance requirements and CPT coding of and other procedures mandated by various payors.

The complexity of laboratory billing also tends to cause delays in our cash collections. Confirming incorrect or missing billing information generally slows down the billing process and increases the age of our accounts receivable. We assume the financial risk related to collection, including the potential write-off of doubtful accounts and delays due to incorrect or missing information.

Our tests and business processes may infringe on the intellectual property rights of others, which could cause us to engage in costly litigation, pay substantial damages or prohibit us from selling our services.

Other companies or individuals, including our competitors, may obtain patents or other property rights that would prevent, limit or interfere with our ability to develop, perform or sell our tests or operate our business. As a result, we may be involved in intellectual property litigation and may be found to infringe on the proprietary rights of others, which could force us to do one or more of the following:

cease developing and performing services that incorporate the challenged intellectual property,

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obtain and pay for licenses from the holder of the infringed intellectual property right,

redesign or reengineer our tests,

change our business processes or

pay substantial damages, court costs and attorneys fees, including potentially increased damages for any infringement determined to be willful.

Infringement and other intellectual property claims, whether with or without merit, can be expensive and time-consuming to litigate. In addition, any requirement to reengineer our tests or change our business processes could substantially increase our costs, force us to interrupt the delivery of our services or delay new test releases.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

The Company is subject to market risk associated principally with changes in interest rates. Our principal interest rate exposure relates to the amount outstanding under the Company s credit facility. The balances outstanding under the credit facility are at floating rates. Based on the outstanding credit facility balance of $272.0 million at June 30, 2006, each quarter point increase or decrease in the floating rate increases or decreases interest expense by approximately $0.6 million per year.

In April 2004, the Company entered into a 2 1/2 year interest rate swap transaction which involves the exchange of fixed for floating rate interest payments without the exchange of the underlying principal amount. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense. The change in the market value of the derivative instrument is recognized in the consolidated statements of income. For the six months ended June 30, 2006 and 2005, the change in the value of the derivative was a gain of approximately $0.7 million and a loss of approximately $0.3 million respectively, which is reflected in the accompanying consolidated statements of income.

ITEM 4. CONTROLS AND PROCEDURES

We are currently in the process of reviewing and formalizing our internal controls and procedures for financial reporting in accordance with the SEC s rules implementing the internal control reporting requirements included in Section 404 of the Sarbanes-Oxley Act of 2002. Changes have been and will be made to our internal controls over financial reporting as a result of these efforts. We are dedicating significant resources, including senior management time and effort, in connection with our ongoing Section 404 assessment in order to allow us to comply with applicable SEC rules and regulations by the filing deadline for our annual report for the calendar year ended December 31, 2007. The evaluation of our internal controls is being conducted under the direction of our senior management in consultation with an independent third party consulting firm. In addition, our senior management is regularly discussing the results of our testing and any proposed improvements to our control environment with our Audit Committee. We will continue to assess our controls and procedures on a regular basis and we will continue to work to improve our controls and procedures and educate and train our employees on our existing controls and procedures in connection with our efforts to maintain an effective controls infrastructure at our Company.

During the course of their audit of our consolidated financial statements for the calendar year ended December 31, 2005, our independent registered public accounting firm, Ernst & Young LLP, advised management and the Audit Committee of our Board of Directors that they had identified one deficiency in internal controls that they considered to be a material weakness as defined under standards established by the American Institute of Certified Public Accountants. The material weakness relates to the adequacy of general controls relating to certain of the Company s information technology systems.

Prior to the identification of the deficiency, we had already undertaken, or were in the process of undertaking, a number of steps to improve the Company s control environment, including:

Significant investments in new systems for the Company, including the recent purchase of an Oracle financial reporting system to replace the Company s current system.

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Retention of outside consulting firms to assist in the Company s Section 404 initiative, including the engagement of a firm to provide guidance specific to IT concerns.

Development of an internal billing information system that will interface with the Oracle financial reporting system.

We have discussed our corrective actions and future plans with our Audit Committee and Ernst & Young LLP. While we believe that the remedial actions that have been or will be taken will result in correcting the condition that is considered to be a material weakness as soon as practicable, the exact timing of when the conditions will be corrected is dependent upon future events which may or may not occur.

Senior management of the Company, including our Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2005. Our management, including our Chief Executive Officer and Chief Financial Officer, has concluded that, except for the internal control deficiency described above and taking into account the efforts to address this deficiency described above, as of the evaluation date, our disclosure controls and procedures are designed, and are effective, to give reasonable assurance that information we must disclose in reports filed with the SEC is properly recorded, processed, and summarized, and then reported within the time periods specified in the rules and forms of the SEC.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we receive subpoenas from government officials. While to date none of these investigations has resulted in liability, investigations are expensive and take valuable management time. In addition, during the ordinary course of business, we have become and may in the future become subject to legal actions and proceedings. We may have liability with respect to our employees and our pathologists and with respect to hospital employees who are under the supervision of our hospital-based pathologists. The majority of these pending legal proceedings involve claims of medical malpractice. Based upon investigations conducted to date, we believe the outcome of pending legal actions and proceedings, individually or in the aggregate, will not have a material adverse effect on our financial condition, results of operations or liquidity. There can be no assurance that our captive insurance arrangements and our excess liability insurance coverage will be adequate to cover all potential medical malpractice liabilities that we may incur. We have no aggregate excess stop loss protection, meaning once our claim limits have been reached, we are subject to loss for any excess amounts. We also may, from time to time, be involved with legal actions related to the acquisition of anatomic pathology operations, the prior conduct of acquired operations or the employment and restriction on competition of physicians. There can be no assurance that any costs or liabilities for which we become responsible in connection with these claims or actions will not be material or will not exceed the limitations of any applicable indemnification provisions or the financial resources of the indemnifying parties.

As reported in the Company s Current Report on Form 8-K dated May 22, 2006, Specialty Laboratories, Inc., a California corporation and a wholly-owned subsidiary of the Company received a subpoena from the California Attorney General s Office. The subpoena seeks various documents including documents relating to billings to the California Medicaid program. The subpoena seeks documents from various time frames ranging from three to ten years. Specialty Laboratories will cooperate with the California Attorney General s Office in responding to the subpoena. It is not possible at this point in the investigation to determine whether the government will pursue action against us or to assess the merits of possible defenses we may have to any such action. Accordingly, no assurances can be given regarding the ultimate outcome of the investigation.

ITEM 6. EXHIBITS

31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934

31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934

32.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(b)/15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350

32.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(b)/15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350

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SIGNATURES

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

AMERIPATH, INC.

Date: August 14, 2006 By: /S/ DONALD E. STEEN
Donald E. Steen

Chairman and Chief Executive Officer

Date: August 14, 2006 By: /S/ DAVID L. REDMOND
David L. Redmond

President and Chief Financial Officer

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EXHIBIT INDEX

Exhibit Number	Description
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32.2	Certification of Principal Financial Officer, as required by Rule 13a-14(b)/15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350