

QUEST DIAGNOSTICS INC
Form 10-Q
July 27, 2010

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-Q

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

For the quarterly period ended June 30, 2010
Commission file number 001-12215

Quest Diagnostics Incorporated

Three Giralda Farms
Madison, NJ 07940
(973) 520-2700

Delaware
(State of Incorporation)

16-1387862
(I.R.S. Employer Identification Number)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

As of July 19, 2010, there were 177,213,693 outstanding shares of the registrant's common stock, \$.01 par value.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2010 AND 2009
(unaudited)
(in thousands, except per share data)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------------------|------------------------------|-------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net revenues | \$ 1,874,727 | \$ 1,901,818 | \$ 3,680,230 | \$ 3,709,824 |
| Operating costs and expenses: | | | | |
| Cost of services | 1,078,971 | 1,100,212 | 2,145,344 | 2,153,701 |
| Selling, general and administrative | 419,412 | 448,756 | 850,145 | 873,057 |
| Amortization of intangible assets | 9,270 | 9,377 | 18,629 | 18,382 |
| Other operating expense (income), net | 1,180 | (15,902) | 1,656 | (15,754) |
| Total operating costs and expenses | 1,508,833 | 1,542,443 | 3,015,774 | 3,029,386 |
| Operating income | 365,894 | 359,375 | 664,456 | 680,438 |
| Other income (expense): | | | | |
| Interest expense, net | (36,367) | (36,846) | (72,322) | (76,254) |
| Equity earnings in unconsolidated joint ventures | 7,385 | 8,382 | 15,349 | 16,952 |
| Other expense, net | (7,119) | (9,095) | (1,107) | (11,804) |
| Total non-operating expenses, net | (36,101) | (37,559) | (58,080) | (71,106) |
| Income from continuing operations before taxes | 329,793 | 321,816 | 606,376 | 609,332 |
| Income tax expense | 125,651 | 123,535 | 231,029 | 233,724 |
| Income from continuing operations | 204,142 | 198,281 | 375,347 | 375,608 |
| (Loss) income from discontinued operations, net of taxes | (266) | 88 | (318) | (1,583) |
| Net income | 203,876 | 198,369 | 375,029 | 374,025 |
| Less: Net income attributable to noncontrolling interests | 9,261 | 10,169 | 17,966 | 18,723 |
| Net income attributable to Quest Diagnostics | \$ 194,615 | \$ 188,200 | \$ 357,063 | \$ 355,302 |
| Amounts attributable to Quest Diagnostics stockholders: | | | | |
| Income from continuing operations | \$ 194,881 | \$ 188,112 | \$ 357,381 | \$ 356,885 |
| (Loss) income from discontinued operations, net of taxes | (266) | 88 | (318) | (1,583) |
| Net income | \$ 194,615 | \$ 188,200 | \$ 357,063 | \$ 355,302 |
| Earnings per share attributable to Quest Diagnostics common stockholders - basic: | | | | |
| Income from continuing operations | \$ 1.08 | \$ 1.01 | \$ 1.98 | \$ 1.90 |
| (Loss) income from discontinued operations | | | | (0.01) |

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| | | | | |
|------------|---------|---------|---------|---------|
| Net income | \$ 1.08 | \$ 1.01 | \$ 1.98 | \$ 1.89 |
|------------|---------|---------|---------|---------|

Earnings per share attributable to Quest Diagnostics common stockholders - diluted:

| | | | | |
|--|---------|---------|---------|---------|
| Income from continuing operations | \$ 1.07 | \$ 1.00 | \$ 1.96 | \$ 1.89 |
| (Loss) income from discontinued operations | | | | (0.01) |

| | | | | |
|------------|---------|---------|---------|---------|
| Net income | \$ 1.07 | \$ 1.00 | \$ 1.96 | \$ 1.88 |
|------------|---------|---------|---------|---------|

Weighted average common shares outstanding:

| | | | | |
|---------|---------|---------|---------|---------|
| Basic | 178,920 | 185,266 | 179,570 | 187,318 |
| Diluted | 180,760 | 187,003 | 181,572 | 188,850 |

| | | | | |
|-----------------------------------|---------|---------|---------|---------|
| Dividends per common share | \$ 0.10 | \$ 0.10 | \$ 0.20 | \$ 0.20 |
|-----------------------------------|---------|---------|---------|---------|

The accompanying notes are an integral part of these statements.

QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2010 AND DECEMBER 31, 2009
(in thousands, except per share data)

| | June 30, 2010 | December 31, 2009 |
|--|--------------------------|------------------------------|
| | (unaudited) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 447,888 | \$ 534,256 |
| Accounts receivable, net of allowance for doubtful accounts of \$242,697 and \$238,206 at June 30, 2010 and December 31, 2009, respectively | 869,643 | 827,343 |
| Inventories | 78,432 | 91,386 |
| Deferred income taxes | 133,403 | 131,800 |
| Prepaid expenses and other current assets | 101,978 | 94,640 |
| | | |
| Total current assets | 1,631,344 | 1,679,425 |
| Property, plant and equipment, net | 804,190 | 825,946 |
| Goodwill, net | 5,063,151 | 5,083,944 |
| Intangible assets, net | 799,834 | 823,665 |
| Other assets | 183,273 | 150,663 |
| | | |
| Total assets | \$ 8,481,792 | \$ 8,563,643 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 824,375 | \$ 888,705 |
| Current portion of long-term debt | 171,128 | 170,507 |
| | | |
| Total current liabilities | 995,503 | 1,059,212 |
| Long-term debt | 2,973,839 | 2,936,792 |
| Other liabilities | 565,562 | 556,175 |
| Stockholders' equity: | | |
| Quest Diagnostics stockholders' equity: | | |
| Common stock, par value \$0.01 per share; 600,000 shares authorized at both June 30, 2010 and December 31, 2009; 214,171 shares and 214,110 shares issued at June 30, 2010 and December 31, 2009, respectively | 2,142 | 2,141 |
| Additional paid-in capital | 2,290,817 | 2,302,368 |
| Retained earnings | 3,537,858 | 3,216,639 |
| Accumulated other comprehensive loss | (48,230) | (20,961) |
| Treasury stock, at cost; 36,994 shares and 30,817 shares at June 30, 2010 and December 31, 2009, respectively | (1,858,255) | (1,510,548) |
| | | |
| Total Quest Diagnostics stockholders' equity | 3,924,332 | 3,989,639 |
| Noncontrolling interests | 22,556 | 21,825 |
| | | |
| Total stockholders' equity | 3,946,888 | 4,011,464 |
| | | |
| Total liabilities and stockholders' equity | \$ 8,481,792 | \$ 8,563,643 |

The accompanying notes are an integral part of these statements.

QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2010 AND 2009
(unaudited)
(in thousands)

| | Six Months Ended June 30, | |
|---|------------------------------|-------------------|
| | 2010 | 2009 |
| Cash flows from operating activities: | | |
| Net income | \$ 375,029 | \$ 374,025 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 126,307 | 130,047 |
| Provision for doubtful accounts | 148,403 | 165,424 |
| Deferred income tax (benefit) provision | (3,702) | 57,021 |
| Stock-based compensation expense | 28,575 | 33,166 |
| Excess tax benefits from stock-based compensation arrangements | (4) | (1,790) |
| Other, net | 11,266 | 9,525 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (193,168) | (228,385) |
| Accounts payable and accrued expenses | (84,590) | (7,764) |
| Settlement and other special charges | | (308,115) |
| Income taxes payable | 41,780 | 8,067 |
| Other assets and liabilities, net | (1,512) | 32,335 |
| Net cash provided by operating activities | 448,384 | 263,556 |
| Cash flows from investing activities: | | |
| Business acquisitions, net of cash acquired | | (12,052) |
| Capital expenditures | (88,848) | (75,996) |
| Increase in investments and other assets | (3,196) | (6,028) |
| Net cash used in investing activities | (92,044) | (94,076) |
| Cash flows from financing activities: | | |
| Proceeds from borrowings | | 510,000 |
| Repayments of debt | (1,487) | (511,185) |
| Purchases of treasury stock | (425,773) | (250,000) |
| Exercise of stock options | 40,174 | 17,225 |
| Excess tax benefits from stock-based compensation arrangements | 4 | 1,790 |
| Dividends paid | (36,430) | (37,616) |
| Distributions to noncontrolling interests | (16,830) | (14,463) |
| Other financing activities | (2,366) | (19,883) |
| Net cash used in financing activities | (442,708) | (304,132) |
| Net change in cash and cash equivalents | (86,368) | (134,652) |
| Cash and cash equivalents, beginning of period | 534,256 | 253,946 |
| Cash and cash equivalents, end of period | \$ 447,888 | \$ 119,294 |

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The accompanying notes are an integral part of these statements.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
 FOR THE SIX MONTHS ENDED JUNE 30, 2010 and 2009
 (unaudited)
 (in thousands)

Quest Diagnostics Stockholders' Equity

| | Shares of Common Stock Outstand- -ing | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Compre- -hensive Loss | Treasury Stock, at Cost | Compre- -hensive Income | Non- -controlling Interests | Total Stock- -holders Equity |
|---|---|-----------------|----------------------------------|----------------------|---|-------------------------------|-------------------------------|-----------------------------------|---------------------------------------|
| Balance, December 31, 2009 | 183,293 | \$ 2,141 | \$ 2,302,368 | \$ 3,216,639 | \$ (20,961) | \$ (1,510,548) | | \$ 21,825 | \$ 4,011,464 |
| Net income | | | | 357,063 | | | \$ 357,063 | 17,966 | 375,029 |
| Currency translation | | | | | (33,186) | | (33,186) | | (33,186) |
| Market valuation, net of tax expense of \$(3,552) | | | | | 5,555 | | 5,555 | | 5,555 |
| Deferred loss, less reclassifications | | | | | 362 | | 362 | | 362 |
| Comprehensive income | | | | | | | \$ 329,794 | | |
| Dividends declared | | | | (35,844) | | | | | (35,844) |
| Distributions to noncontrolling interests | | | | | | | | (16,830) | (16,830) |
| Issuance of common stock under benefit plans | 869 | 2 | (24,377) | | | 34,618 | | | 10,243 |
| Stock-based compensation expense | | | 26,768 | | | 1,807 | | | 28,575 |
| Exercise of stock options | 1,027 | | (11,081) | | | 51,255 | | | 40,174 |
| Shares to cover employee payroll tax withholdings on stock issued under benefit plans | (271) | (1) | (5,489) | | | (9,614) | | | (15,104) |
| Tax benefits associated with stock-based compensation plans | | | 2,628 | | | | | | 2,628 |
| Purchases of treasury stock | (7,741) | | | | | (425,773) | | | (425,773) |
| Other | | | | | | | | (405) | (405) |
| Balance, June 30, 2010 | 177,177 | \$ 2,142 | \$ 2,290,817 | \$ 3,537,858 | \$ (48,230) | \$ (1,858,255) | | \$ 22,556 | \$ 3,946,888 |

Quest Diagnostics Stockholders' Equity

| | Shares of Common Stock Outstand- -ing | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Compre- -hensive Loss | Treasury Stock, at Cost | Compre- -hensive Income | Non- -controlling Interests | Total Stock- -holders Equity |
|--|---|-----------------|----------------------------------|----------------------|---|-------------------------------|-------------------------------|-----------------------------------|---------------------------------------|
| Balance, December 31, 2008 | 190,374 | \$ 2,141 | \$ 2,262,065 | \$ 2,561,679 | \$ (68,068) | \$ (1,152,921) | | \$ 20,238 | \$ 3,625,134 |
| Net income | | | | 355,302 | | | \$ 355,302 | 18,723 | 374,025 |
| Currency translation | | | | | 10,955 | | 10,955 | | 10,955 |
| Market valuation, net of tax expense of \$(190) | | | | | 290 | | 290 | | 290 |
| Deferred loss, less reclassifications | | | | | 1,234 | | 1,234 | | 1,234 |
| Comprehensive income | | | | | | | \$ 367,781 | | |

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| | | | | | | | | |
|---|----------------|-----------------|---------------------|---------------------|--------------------|-----------------------|------------------|---------------------|
| Dividends declared | | | | (37,259) | | | | (37,259) |
| Distributions to noncontrolling interests | | | | | | | (14,463) | (14,463) |
| Issuance of common stock under benefit plans | 500 | | 368 | | | 9,402 | | 9,770 |
| Stock-based compensation expense | | | 20,878 | | | 12,288 | | 33,166 |
| Exercise of stock options | 559 | | (9,701) | | | 26,926 | | 17,225 |
| Shares to cover employee payroll tax withholdings on stock issued under benefit plans | (129) | | (1,822) | | | (3,995) | | (5,817) |
| Tax benefits associated with stock-based compensation plans | | | 1,382 | | | | | 1,382 |
| Purchase of treasury stock | (5,620) | | | | | (250,000) | | (250,000) |
| Balance, June 30, 2009 | 185,684 | \$ 2,141 | \$ 2,273,170 | \$ 2,879,722 | \$ (55,589) | \$ (1,358,300) | \$ 24,498 | \$ 3,765,642 |

The accompanying notes are an integral part of these statements.

QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, unless otherwise indicated)
(unaudited)

1. DESCRIPTION OF BUSINESS

Background

Quest Diagnostics Incorporated and its subsidiaries (Quest Diagnostics or the Company) is the world's leading provider of diagnostic testing, information and services, providing insights that enable patients, physicians and others to make decisions to improve health. Quest Diagnostics offers patients and physicians the broadest access to diagnostic laboratory services through the Company's nationwide network of laboratories and patient service centers. The Company provides interpretive consultation through the largest medical and scientific staff in the industry, with approximately 900 M.D.s and Ph.D.s primarily located in the United States. Quest Diagnostics is the leading provider of clinical testing, including gene-based testing and other esoteric testing, anatomic pathology services and testing for drugs-of-abuse, and the leading provider of risk assessment services for the life insurance industry. The Company is also a leading provider of testing for clinical trials. The Company's diagnostics products business manufactures and markets diagnostic test kits and specialized point-of-care testing. Quest Diagnostics empowers healthcare organizations and clinicians with state-of-the-art information technology solutions that can improve patient care and medical practice.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The interim consolidated financial statements reflect all adjustments which in the opinion of management are necessary for a fair statement of financial condition, results of operations, and cash flows for the periods presented. Except as otherwise disclosed, all such adjustments are of a normal recurring nature. The interim consolidated financial statements have been compiled without audit. Operating results for the interim periods are not necessarily indicative of the results that may be expected for the full year. These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's 2009 Annual Report on Form 10-K.

The year-end balance sheet data was derived from the audited financial statements as of December 31, 2009, but does not include all the disclosures required by accounting principles generally accepted in the United States (GAAP).

Certain reclassifications have been made to prior year amounts in the statement of cash flows to conform to the current year presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Earnings Per Share

The Company's unvested restricted common stock and unvested restricted stock units that contain non-forfeitable rights to dividends are participating securities and, therefore, are included in the earnings allocation in computing earnings per share using the two-class method. Basic earnings per common share is calculated by dividing net income, adjusted for earnings allocated to participating securities, by the weighted average number of common shares outstanding. Diluted earnings per common share is calculated by dividing net income, adjusted for earnings allocated to participating securities, by the weighted average number of common shares outstanding after giving effect to all potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the dilutive effect of outstanding stock options and performance share units granted under the Company's Amended and Restated Employee Long-Term Incentive Plan and its Amended and Restated Non-Employee Director Long-Term Incentive Plan.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED (in thousands, unless otherwise indicated) (unaudited)

New Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting standards related to the consolidation of variable interest entities (VIE). This standard provides a new approach for determining which entity should consolidate a VIE, how and when to reconsider the consolidation or deconsolidation of a VIE and requires disclosures about an entity's significant judgments and assumptions used in its decision to consolidate or not consolidate a VIE. Under this standard, the new consolidation model is a more qualitative assessment of power and economics that considers which entity has the power to direct the activities that most significantly impact the VIE's economic performance and has the obligation to absorb losses of, or the right to receive benefits that could be potentially significant to, the VIE. The adoption of this standard on January 1, 2010 was not material to the Company's consolidated financial statements.

In October 2009, the FASB issued an amendment to the accounting standards related to the accounting for revenue in arrangements with multiple deliverables including how the arrangement consideration is allocated among delivered and undelivered items of the arrangement. Among the amendments, this standard eliminates the use of the residual method for allocating arrangement consideration and requires an entity to allocate the overall consideration to each deliverable based on an estimated selling price of each individual deliverable in the arrangement in the absence of having vendor-specific objective evidence or other third party evidence of fair value of the undelivered items. This standard also provides further guidance on how to determine a separate unit of accounting in a multiple-deliverable revenue arrangement and expands the disclosure requirements about the judgments made in applying the estimated selling price method and how those judgments affect the timing or amount of revenue recognition. This standard, for which the Company is currently assessing the impact, will become effective for the Company on January 1, 2011.

In October 2009, the FASB issued an amendment to the accounting standards related to certain revenue arrangements that include software elements. This standard clarifies the existing accounting guidance such that tangible products that contain both software and non-software components that function together to deliver the product's essential functionality, shall be excluded from the scope of the software revenue recognition accounting standards. Accordingly, sales of these products may fall within the scope of other revenue recognition accounting standards or may now be within the scope of this standard and may require an allocation of the arrangement consideration for each element of the arrangement. This standard, for which the Company is currently assessing the impact, will become effective for the Company on January 1, 2011.

In January 2010, the FASB issued an amendment to the accounting standards related to the disclosures about an entity's use of fair value measurements. Among these amendments, entities will be required to provide enhanced disclosures about transfers into and out of the Level 1 (fair value determined based on quoted prices in active markets for identical assets and liabilities) and Level 2 (fair value determined based on significant other observable inputs) classifications, provide separate disclosures about purchases, sales, issuances and settlements relating to the tabular reconciliation of beginning and ending balances of the Level 3 (fair value determined based on significant unobservable inputs) classification and provide greater disaggregation for each class of assets and liabilities that use fair value measurements. Except for the detailed Level 3 roll-forward disclosures, the new standard was effective for the Company for interim and annual reporting periods beginning after December 31, 2009. The adoption of this accounting standards amendment did not have a material impact on the Company's consolidated financial statements. The requirement to provide detailed disclosures about the purchases, sales, issuances and settlements in the roll-forward activity for Level 3 fair value measurements is effective for the Company for interim and annual reporting periods beginning after December 31, 2010. The Company does not expect that the adoption of these new disclosure requirements will have a material impact on its consolidated financial statements.

In February 2010, the FASB issued an amendment to the accounting standards related to the accounting for, and disclosure of, subsequent events in an entity's consolidated financial statements. This standard amends the authoritative guidance for subsequent events that was previously issued and among other things exempts Securities and Exchange Commission registrants from the requirement to disclose the date through which it has evaluated subsequent events for either original or restated financial statements. This standard does not apply to subsequent events or transactions that are within the scope of other applicable GAAP that provides different guidance on the accounting treatment for subsequent

QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
(in thousands, unless otherwise indicated)
(unaudited)

events or transactions. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

3. EARNINGS PER SHARE

The computation of basic and diluted earnings per common share was as follows (in thousands, except per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------|------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Amounts attributable to Quest Diagnostics stockholders: | | | | |
| Income from continuing operations | \$ 194,881 | \$ 188,112 | \$ 357,381 | \$ 356,885 |
| (Loss) income from discontinued operations | (266) | 88 | (318) | (1,583) |
| Net income available to Quest Diagnostics' common stockholders | \$ 194,615 | \$ 188,200 | \$ 357,063 | \$ 355,302 |
| Income from continuing operations | \$ 194,881 | \$ 188,112 | \$ 357,381 | \$ 356,885 |
| Less: Earnings allocated to participating securities | 928 | 568 | 1,588 | 894 |
| Earnings available to Quest Diagnostics' common stockholders - basic and diluted | \$ 193,953 | \$ 187,544 | \$ 355,793 | \$ 355,991 |
| Weighted average common shares outstanding - basic | 178,920 | 185,266 | 179,570 | 187,318 |
| Effect of dilutive securities: | | | | |
| Stock options and performance share units | 1,840 | 1,737 | 2,002 | 1,532 |
| Weighted average common shares outstanding - diluted | 180,760 | 187,003 | 181,572 | 188,850 |
| Earnings per share attributable to Quest Diagnostics common stockholders - basic: | | | | |
| Income from continuing operations | \$ 1.08 | \$ 1.01 | \$ 1.98 | \$ 1.90 |
| (Loss) income from discontinued operations | | | | (0.01) |
| Net income | \$ 1.08 | \$ 1.01 | \$ 1.98 | \$ 1.89 |
| Earnings per share attributable to Quest Diagnostics common stockholders - diluted: | | | | |
| Income from continuing operations | \$ 1.07 | \$ 1.00 | \$ 1.96 | \$ 1.89 |
| (Loss) income from discontinued operations | | | | (0.01) |
| Net income | \$ 1.07 | \$ 1.00 | \$ 1.96 | \$ 1.88 |

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Stock options and performance share units of 3.1 million shares and 2.9 million shares for the three and six months ended June 30, 2010, respectively, were not included due to their antidilutive effect.

Stock options and performance share units of 3.9 million shares and 4.2 million shares for the three and six months ended June 30, 2009, respectively, were not included due to their antidilutive effect.

4. FAIR VALUE MEASUREMENTS

The Company determines fair value measurements used in its consolidated financial statements based upon the exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants exclusive of any transaction costs, as determined by either the principal market or the most advantageous market. The principal market is the market with the greatest level of activity and volume for the asset or liability. Absent a principal market to measure fair value, the Company has used the most advantageous market, which is the market in which the Company would receive the highest selling price for the asset or pay the lowest price to settle the liability, after considering transaction costs. However, when using the most advantageous market, transaction costs are only considered to determine which market is the most advantageous and these costs are then excluded when applying a fair value measurement.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
 (in thousands, unless otherwise indicated)
 (unaudited)

Inputs used in the valuation techniques to derive fair values are classified based on a three-level hierarchy. The basis for fair value measurements for each level within the hierarchy is described below with Level 1 having the highest priority and Level 3 having the lowest.

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

Level 2: Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable in active markets.

Level 3: Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

The following table provides a summary of the recognized assets and liabilities that are measured at fair value on a recurring basis:

Basis of Fair Value Measurements

| | Basis of Fair Value Measurements | | |
|---|---|--|---------------------------------------|
| | Quoted Prices in Active Markets for Identical Assets / Liabilities | Significant Other Observable Inputs | Significant Unobservable Inputs |
| | Level 1 | Level 2 | Level 3 |
| June 30, 2010 | | | |
| Assets: | | | |
| Trading securities | \$ 32,568 | \$ 32,568 | \$ |
| Interest rate swaps | 21,075 | 21,075 | |
| Cash surrender value of life insurance policies | 17,572 | 17,572 | |
| Available-for-sale equity securities | 9,107 | | 9,107 |
| Stock warrants | 686 | | 686 |
| Foreign currency forward contracts | 2,281 | 2,281 | |
| Total | \$ 83,289 | \$ 40,928 | \$ 9,793 |
| Liabilities: | | | |
| Deferred compensation liabilities | \$ 52,911 | \$ 52,911 | \$ |
| Foreign currency forward contracts | 3,252 | 3,252 | |
| Total | \$ 56,163 | \$ 56,163 | \$ |

Basis of Fair Value Measurements

| Quoted Prices in Active Markets for Identical Assets / Liabilities | Significant Other Observable Inputs | Significant Unobservable Inputs |
|---|--|---------------------------------------|
|---|--|---------------------------------------|

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| December 31, 2009 | | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
|---|-------------------|-------------------|-------------------|-------------------|
| Assets: | | | | |
| Trading securities | \$ 33,871 | \$ 33,871 | \$ | \$ |
| Cash surrender value of life insurance policies | 15,873 | | 15,873 | |
| Foreign currency forward contracts | 2,357 | | 2,357 | |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total | \$ 52,101 | \$ 33,871 | \$ 18,230 | \$ |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Liabilities: | | | | |
| Deferred compensation liabilities | \$ 53,919 | \$ | \$ 53,919 | \$ |
| Interest rate swaps | 14,398 | | 14,398 | |
| Foreign currency forward contracts | 311 | | 311 | |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total | \$ 68,628 | \$ | \$ 68,628 | \$ |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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The Company offers certain employees the opportunity to participate in a supplemental deferred compensation plan. A participant's deferrals, together with Company matching credits, are invested in a variety of participant-directed stock and bond mutual funds that are classified as trading securities. Changes in the fair value of these securities are measured using quoted prices in active markets based on the market price per unit multiplied by the number of units held exclusive of any transaction costs. A corresponding adjustment for changes in fair value of the trading securities is also reflected in the changes in fair value of the deferred compensation obligation. The deferred compensation liabilities are classified within Level 2 because their inputs are derived principally from observable market data by correlation to the trading securities.

The Company offers certain employees the opportunity to participate in a non-qualified deferred compensation program. A participant's deferrals, together with Company matching credits, are invested at the direction of the employee in a hypothetical portfolio of investments which are tracked by an administrator. The Company purchases life insurance policies, with the Company named as beneficiary of the policies, for the purpose of funding the program's liability. Changes in the cash surrender value of the life insurance policies are based upon earnings and changes in the value of the underlying investments. Changes in the fair value of the deferred compensation obligation are derived using quoted prices in active markets based on the market price per unit multiplied by the number of units. The cash surrender value and the deferred compensation obligations are classified within Level 2 because their inputs are derived principally from observable market data by correlation to the hypothetical investments.

The fair value measurements of foreign currency forward contracts are obtained from a third-party pricing service and are based on market prices in actual transactions and other relevant information generated by market transactions involving identical or comparable assets or liabilities. The fair value measurements of the Company's interest rate swaps are model-derived valuations as of a given date in which all significant inputs are observable in active markets including certain financial information and certain assumptions regarding past, present and future market conditions. The Company does not believe that the changes in the fair values of its foreign currency forward contracts and interest rate swaps will materially differ from the amounts that could be realized upon settlement or maturity or that the changes in fair value will have a material effect on its results of operations, liquidity and capital resources.

Investments in available-for-sale equity securities consist of the revaluation of an existing investment in unregistered common shares of a publicly-held company. This investment is classified within Level 3 because the unregistered securities contain restrictions on their sale and, therefore, the fair value measurement reflects a discount for the effect of the restriction.

The stock warrants are a derivative financial instrument that gives the Company the right to purchase unregistered common shares of a publicly-held company. The fair value measurements of the warrants are derived from an option pricing model that includes certain unobservable inputs and assumptions by the Company's management for an asset with limited market activity and are therefore classified within Level 3. The tabular reconciliations of beginning and ending balances and activities for Level 3 assets have been omitted due to immateriality.

In June 2009, the Company recorded a charge of \$7.0 million associated with the write-down of an investment due to the uncertainty of recoverability from an other-than-temporary impairment loss. A fair value measurement, using significant unobservable inputs, has been applied to this asset on a non-recurring basis.

The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable and accrued expenses approximate fair value based on the short maturities of these instruments. At both June 30, 2010 and December 31, 2009, the fair value of the Company's debt was estimated at \$3.3 billion using quoted market prices and yields for the same or similar types of borrowings, taking into account the underlying terms of the debt instruments. At June 30, 2010 and December 31, 2009, the estimated fair value exceeded the carrying value of the debt by \$164 million and \$151 million, respectively.

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5. GOODWILL AND INTANGIBLE ASSETS

The changes in goodwill, net for the six months ended June 30, 2010 and for the year ended December 31, 2009 are as follows:

| | <u>June 30, 2010</u> | <u>December 31, 2009</u> |
|---|--------------------------|------------------------------|
| Balance at beginning of period | \$ 5,083,944 | \$ 5,054,926 |
| Goodwill acquired during the year | | 25,973 |
| Other purchase accounting adjustments | 246 | (21,195) |
| (Decrease) increase related to foreign currency translation | (21,039) | 24,240 |
| | <u>5,063,151</u> | <u>5,083,944</u> |
| Balance at end of period | <u>\$ 5,063,151</u> | <u>\$ 5,083,944</u> |

Approximately 90% of the Company's goodwill as of June 30, 2010 and December 31, 2009 was associated with its clinical testing business.

For the year ended December 31, 2009, goodwill acquired during the year was associated with several immaterial acquisitions. For the six months ended June 30, 2010, other purchase accounting adjustments were primarily related to a milestone payment on an acquisition from 2008. For the year ended December 31, 2009, other purchase accounting adjustments were primarily related to a payment received from an escrow fund established at the time of an acquisition in 2007.

Intangible assets at June 30, 2010 and December 31, 2009 consisted of the following:

| | <u>Weighted Average Amortization Period</u> | <u>June 30, 2010</u> | | | <u>December 31, 2009</u> | | |
|---|---|----------------------|-------------------------------------|------------|--------------------------|-------------------------------------|------------|
| | | <u>Cost</u> | <u>Accumulated Amortization</u> | <u>Net</u> | <u>Cost</u> | <u>Accumulated Amortization</u> | <u>Net</u> |
| Amortizing intangible assets: | | | | | | | |
| Customer-related intangibles | 19 years | \$ 597,374 | \$ (144,791) | \$ 452,583 | \$ 600,460 | \$ (129,994) | \$ 470,466 |
| Non-compete agreements | 5 years | 54,847 | (51,152) | 3,695 | 54,854 | (50,252) | 4,602 |
| Other | 10 years | 69,808 | (20,563) | 49,245 | 68,896 | (18,867) | 50,029 |
| Total | 18 years | 722,029 | (216,506) | 505,523 | 724,210 | (199,113) | 525,097 |
| Intangible assets not subject to amortization: | | | | | | | |
| Tradenames | | 294,311 | | 294,311 | 298,568 | | 298,568 |
| Total intangible assets | | \$ 1,016,340 | \$ (216,506) | \$ 799,834 | \$ 1,022,778 | \$ (199,113) | \$ 823,665 |

Amortization expense related to intangible assets was \$9.3 million and \$9.4 million for the three months ended June 30, 2010 and 2009, respectively. For the six months ended June 30, 2010 and 2009, amortization expense related to intangible assets was \$18.6 million and \$18.4 million, respectively.

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The estimated amortization expense related to intangible assets for each of the five succeeding fiscal years and thereafter as of June 30, 2010 is as follows:

| Fiscal Year Ending December 31, | |
|--|------------|
| <hr/> | |
| Remainder of 2010 | \$ 20,399 |
| 2011 | 40,269 |
| 2012 | 38,644 |
| 2013 | 36,424 |
| 2014 | 35,833 |
| 2015 | 34,344 |
| Thereafter | 299,610 |
| | <hr/> |
| Total | \$ 505,523 |
| | <hr/> |

6. FINANCIAL INSTRUMENTS

The Company uses derivative financial instruments to manage its exposure to market risks for changes in interest rates and foreign currency. This strategy includes the use of interest rate swap agreements, forward starting interest rate swap agreements and foreign currency forward contracts to manage its exposure to movements in interest and currency rates. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. These policies prohibit holding or issuing derivative financial instruments for speculative or trading purposes. The Company does not enter into derivative financial instruments that contain credit-risk-related contingent features or requirements to post collateral.

A summary of the fair values of derivative instruments in the consolidated balance sheets is stated in the table below:

| | June 30, 2010 | | December 31, 2009 | |
|--|---|-------------------|---|-------------------|
| | Balance Sheet Classification | Fair Value | Balance Sheet Classification | Fair Value |
| <hr/> | | | | |
| Derivatives Designated as Hedging Instruments | | | | |
| Asset Derivatives: | | | | |
| Interest rate swaps | Other assets | \$ 21,075 | \$ | |
| | | <hr/> | | <hr/> |
| Liability Derivatives: | | | | |
| Interest rate swaps | | \$ | Other liabilities | \$ 14,398 |
| | | <hr/> | | <hr/> |
| Derivatives Not Designated as Hedging Instruments | | | | |
| Asset Derivatives: | | | | |
| Foreign currency forward contracts | Other current assets | 2,281 | Other current assets | 2,357 |
| Stock warrants | Other assets | 686 | | |
| | | <hr/> | | <hr/> |
| Total | | 2,967 | | 2,357 |
| | | <hr/> | | <hr/> |

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| | | | | |
|--|---------------------------|-------------------|---------------------------|-------------------|
| Liability Derivatives: | | | | |
| Foreign currency forward contracts | Other current liabilities | 3,252 | Other current liabilities | 311 |
| | | <u> </u> | | <u> </u> |
| Total Net Derivatives Asset | | <u>\$ 20,790</u> | | <u>\$</u> |
| Total Net Derivatives Liability | | <u>\$</u> | | <u>\$ 12,352</u> |

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
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Interest Rate Risk

The Company is exposed to interest rate risk on its cash and cash equivalents and its debt obligations. Interest income earned on cash and cash equivalents may fluctuate as interest rates change, however, due to their relatively short maturities, the Company does not hedge these assets and the impact of interest rate risk is not material. The Company's debt obligations consist of fixed-rate and variable-rate debt instruments. The Company's primary objective is to achieve the lowest overall cost of funding while managing the variability in cash outflows within an acceptable range. In order to achieve these objectives, the Company has entered into interest rate swaps. Interest rate swaps involve the periodic exchange of payments without the exchange of underlying principal or notional amounts. Net payments are recognized as an adjustment to interest expense.

The Company formally documents its hedge relationships, including identifying the hedging instruments and the hedged items, as well as its risk management objectives and strategies for undertaking the hedge transaction. On the date the derivative is entered into, the Company designates the type of derivative as a fair value hedge or cash flow hedge, and accounts for the derivative in accordance with its designation as prescribed by the FASB standards on accounting for derivative instruments and hedging activities. At inception and at least quarterly thereafter, the Company formally assesses whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in the fair value or cash flows of the hedged item. All components of each derivative financial instrument's gain or loss are included in the assessment of hedge effectiveness.

In November 2009, the Company entered into various fixed-to-variable interest rate swap agreements (the Fixed-to-Variable Interest Rate Swap Agreements) which have a notional amount totaling \$350 million and a variable interest rate based on one-month LIBOR plus 1.33%. These derivative financial instruments are accounted for as fair value hedges of a portion of our Senior Notes due 2020 and effectively convert that portion of the debt into variable interest rate debt. Accordingly, the Company recognizes the changes in the fair value of both the Fixed-to-Variable Interest Rate Swap Agreements and the underlying debt obligation in other expense, net as equal and offsetting gains and losses. The fair value of the Fixed-to-Variable Interest Rate Swap Agreements was an asset of \$21.1 million at June 30, 2010 and a liability of \$14.4 million, at December 31, 2009. Since inception, the fair value hedges were effective; therefore, there is no impact on earnings for the three or six months ended June 30, 2010 as a result of hedge ineffectiveness.

In previous years, the Company entered into various forward starting interest rate swap agreements and treasury-lock agreements that were accounted for as cash flow hedges. The effective portions of the changes in fair value of these derivatives represent deferred gains or losses that are recorded in accumulated other comprehensive loss. These deferred gains or losses are reclassified from accumulated other comprehensive loss to the statement of operations in the same period or periods during which the hedged transaction affects earnings, which is when the Company recognizes interest expense on the hedged cash flows. The total loss, net of tax benefit, recognized in accumulated other comprehensive loss on these cash flow hedges as of June 30, 2010 and December 31, 2009 was \$7.0 million and \$7.3 million, respectively. The net amount of deferred gains and losses on cash flow hedges that is expected to be reclassified from accumulated other comprehensive loss into earnings within the next 12 months is \$1.1 million.

Foreign Currency Risk

The Company is exposed to market risk for changes in foreign exchange rates primarily under certain intercompany receivables and payables. Foreign exchange forward contracts are used to mitigate the exposure of the eventual net cash inflows or outflows resulting from these intercompany transactions. The objective is to hedge a portion of the forecasted foreign currency risk over a rolling 12-month time horizon to mitigate the eventual impacts of changes in foreign exchange rates on the cash flows of the intercompany transactions. As of June 30, 2010, the gross notional amount of foreign currency forward contracts in U.S. dollars was \$99.3 million and principally consists of contracts in Swedish krona and British pounds. Notional amounts represent the face amount of contractual arrangements and the basis on which currencies are exchanged and are not a measure of market or credit risk exposure. The Company does not designate these derivative instruments as hedges under current accounting standards unless the benefits of doing so are material. The Company's foreign exchange exposure is not material to the Company's consolidated financial condition or

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results of operations. The Company does not hedge its net investment in non-U.S. subsidiaries because it views those investments as long-term in nature.

Stock Warrants

The stock warrants are a derivative financial instrument that gives the Company the right to purchase unregistered common shares of a publicly-held company and the fair value is derived from an option pricing model.

7. STOCKHOLDERS EQUITY

Components of Comprehensive Income

The market valuation adjustment for the six months ended June 30, 2010 represents unrealized holding gains on investments, net of taxes. The deferred loss for the six months ended June 30, 2010 primarily represents deferred losses on the Company's interest rate swap and forward starting interest rate swap agreements, net of amounts reclassified to interest expense. Foreign currency translation adjustments are not adjusted for income taxes since they relate to indefinite investments in non-U.S. subsidiaries.

The market valuation adjustment for the six months ended June 30, 2009 represents the reversal of prior period unrealized holding losses for investments, net of taxes, where the decline in fair value was deemed to be other than temporary and the resulting loss was recognized in the consolidated statement of operations. The deferred loss primarily represents deferred losses on the Company's interest rate swap agreements, net of amounts reclassified to interest expense. Foreign currency translation adjustments are not adjusted for income taxes since they relate to indefinite investments in non-U.S. subsidiaries.

Comprehensive Income

For the three months ended June 30, 2010 and 2009, total comprehensive income was \$169 million and \$220 million, respectively.

Dividend Program

During each of the quarters of 2010 and 2009, the Company's Board of Directors has declared a quarterly cash dividend of \$0.10 per common share.

Share Repurchase Plan

In January 2010, the Company's Board of Directors authorized the Company to repurchase an additional \$750 million of the Company's common stock. The share repurchase authorization has no set expiration or termination date.

For the three months ended June 30, 2010, the Company repurchased 3.3 million shares of its common stock at an average price of \$53.36 per share for a total of \$175 million. For the six months ended June 30, 2010, the Company repurchased 7.7 million shares of its common stock at an average price of \$55.00 per share for \$426 million, including 4.5 million shares purchased in the first quarter at an average price per share of \$56.21 for \$251 million under an accelerated share repurchase transaction (ASR) with a bank.

Under the ASR, in January 2010, the Company repurchased 4.5 million shares of the Company's outstanding common stock for an initial purchase price of \$56.05 per share. The purchase price of these shares was subject to an adjustment based on the volume weighted average price of the Company's common stock during a period following execution of the agreement. The total cost of the initial purchase was \$250 million. The purchase price adjustment was settled in the first quarter of 2010 and resulted in an additional cash payment of \$0.7 million, for a final purchase price of \$251 million, or \$56.21 per share.

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For the three and six months ended June 30, 2010, the Company reissued 0.6 million shares and 1.6 million shares, respectively for employee benefit plans. At June 30, 2010, \$324 million of share repurchase authorization remained available.

The Company did not purchase any shares of its common stock during the second quarter of 2009. For the six months ended June 30, 2009, the Company repurchased approximately 5.6 million shares of its common stock at an average price of \$44.48 per share for \$250 million, including 4.5 million shares repurchased from SB Holdings Capital Inc., a wholly-owned subsidiary of GlaxoSmithKline plc., at an average price of \$44.33 per share for \$200 million. For the three and six months ended June 30, 2009, the Company reissued 0.4 million shares and 0.9 million shares, respectively, for employee benefit plans.

8. SUPPLEMENTAL CASH FLOW & OTHER DATA

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-----------------------|--------------------------------|-----------|------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Depreciation expense | \$ 53,704 | \$ 55,811 | \$ 107,678 | \$ 111,665 |
| Interest expense | (36,640) | (36,961) | (73,170) | (76,805) |
| Interest income | 273 | 115 | 848 | 551 |
| Interest expense, net | (36,367) | (36,846) | (72,322) | (76,254) |
| Interest paid | 21,103 | 29,720 | 56,415 | 76,857 |
| Income taxes paid | 190,289 | 136,153 | 197,118 | 167,500 |

9. COMMITMENTS AND CONTINGENCIES

The Company has a line of credit with a financial institution totaling \$85 million for the issuance of letters of credit (the Letter of Credit Line). The Letter of Credit Line, which is renewed annually, matures on November 19, 2010 and is guaranteed by certain of the Company's domestic, wholly-owned subsidiaries (the Subsidiary Guarantors).

In support of its risk management program, to ensure the Company's performance or payment to third parties, \$72 million in letters of credit were outstanding at June 30, 2010. The letters of credit primarily represent collateral for current and future automobile liability and workers' compensation loss payments. In addition, \$6 million of bank guarantees were outstanding at June 30, 2010 in support of certain foreign operations.

Contingent Lease Obligations

The Company is subject to contingent obligations under certain leases and other instruments incurred in connection with real estate activities and other operations associated with LabOne, Inc., which the Company acquired in 2005, and certain of its predecessor companies. No liability has been recorded for any of these potential contingent obligations. See Note 15 to the Consolidated Financial Statements contained in the Company's 2009 Annual Report on Form 10-K for further details.

Legal Matters

The Company is involved in various legal proceedings. Some of the proceedings against the Company involve claims that are substantial in amount.

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In 2005, the Company received a subpoena from the U. S. Attorney's Office for the District of New Jersey. The subpoena seeks the production of business and financial records regarding capitation and risk sharing arrangements with government and private payers for the years 1993 through 1999. The Company cooperated with the U. S. Attorney's Office.

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In 2005, the Company received a subpoena from the U. S. Department of Health and Human Services, Office of the Inspector General, seeking business records including records regarding the Company's relationship with health maintenance organizations, independent physician associations, group purchasing organizations, and preferred provider organizations relating back to 1995. The Company has cooperated with the investigation. Subsequently, in November 2009, the U.S. District Court for the Southern District of New York partially unsealed a civil complaint, U. S. ex rel. Fair Laboratory Practices Associates v. Quest Diagnostics Incorporated, filed against the Company under the whistleblower provisions of the federal False Claims Act. The complaint alleges, among other things, violations of the federal Anti-Kickback Statute and the federal False Claims Act in connection with the Company's pricing of laboratory services. The complaint seeks damages for alleged false claims associated with laboratory tests reimbursed by government payors, treble damages and civil penalties.

In 2006 and 2008, the Company and several of its subsidiaries received subpoenas from the California Attorney General's Office seeking documents relating to the Company's billings to MediCal, the California Medicaid program. The Company has cooperated with the government's requests. Subsequently, the State of California intervened as plaintiff in a civil lawsuit, California ex rel. Hunter Laboratories, LLC v. Quest Diagnostics Incorporated., et al., filed in California Superior Court against a number of clinical laboratories, including the Company and several of its subsidiaries. The complaint alleges, among other things, overcharging of MediCal for testing services. The complaint was originally filed by a competitor laboratory in California under the whistleblower provisions of the California False Claims Act. The complaint was unsealed on March 20, 2009.

In June 2009, a shareholder plaintiff filed a purported derivative action in the Superior Court of New Jersey, Morris County, on behalf of the Company against certain present and former directors and officers of the Company based on, among other things, their alleged breaches of fiduciary duties in connection with the manufacture, marketing, sale and billing related to certain test kits manufactured by NID. The complaint includes claims for, among other things, breach of fiduciary duty and waste of corporate assets and seeks, among other things, damages and remission of compensation received by the individual defendants.

In April 2010, a putative class action was filed against the Company and NID in the U.S. District Court for the Eastern District of New York on behalf of entities that allegedly purchased or paid for certain of NID's test kits. The complaint alleges that certain of NID's test kits were defective and that defendants, among other things, violated RICO and state consumer protection laws. The complaint alleges an unspecified amount of damages.

The Company and certain of its subsidiaries have received subpoenas from state agencies in five states which seek documents relating to the Company's Medicaid billing practices in those states. The Company is cooperating with the requests.

The federal or state governments may bring claims based on new theories as to the Company's practices which management believes to be in compliance with law. In addition, certain federal and state statutes, including the qui tam provisions of the federal False Claims Act, allow private individuals to bring lawsuits against healthcare companies on behalf of government or private payers. The Company is aware of certain pending individual or class action lawsuits, and has received several subpoenas, related to billing practices filed under the qui tam provisions of the Civil False Claims Act and/or other federal and state statutes, regulations or other laws. The Company understands that there may be other pending qui tam claims brought by former employees or other whistle blowers as to which the Company cannot determine the extent of any potential liability.

Several of these matters are in their early stages of development and involve responding to and cooperating with various government investigations and related subpoenas. While the Company believes that at least a reasonable possibility exists that losses may have been incurred, based on the nature and status of the investigations, the losses are either currently not probable or cannot be reasonably estimated.

Management has established reserves in accordance with generally accepted accounting principles for the matters discussed above. Such reserves totaled approximately \$10 million as of June 30, 2010. Although management cannot predict the outcome of such matters, management does not anticipate that the ultimate outcome of such matters

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will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such matters is determined or paid.

As a general matter, providers of clinical testing services may be subject to lawsuits alleging negligence or other similar legal claims. These suits could involve claims for substantial damages. Any professional liability litigation could also have an adverse impact on the Company's client base and reputation. The Company maintains various liability insurance coverages for, among other things, claims that could result from providing, or failing to provide, clinical testing services, including inaccurate testing results, and other exposures. The Company's insurance coverage limits its maximum exposure on individual claims; however, the Company is essentially self-insured for a significant portion of these claims. Reserves for such matters are established by considering actuarially determined losses based upon the Company's historical and projected loss experience. Management believes that present insurance coverage and reserves are sufficient to cover currently estimated exposures. Although management cannot predict the outcome of any claims made against the Company, management does not anticipate that the ultimate outcome of any such proceedings or claims will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such claims is determined or paid.

10. DISCONTINUED OPERATIONS

During the fourth quarter of 2005, NID instituted its second voluntary product hold within a six-month period due to quality issues, which adversely impacted the operating performance of NID. As a result, the Company evaluated a number of strategic options for NID. On April 19, 2006, the Company decided to discontinue NID's operations. During the third quarter of 2006, the Company completed its wind down of NID and classified the operations of NID as discontinued operations. Results of operations for NID have been reported as discontinued operations in the accompanying consolidated statements of operations and related disclosures for all periods presented.

During the third quarter of 2007, the government and the Company began settlement discussions with respect to the government's investigation involving NID and the Company. Based on the status of settlement discussions, during 2007 the Company established a reserve, in accordance with generally accepted accounting principles, reflected in discontinued operations, of \$241 million in connection with these claims.

During the third quarter of 2008, the Company and NID reached an agreement in principle with the United States Attorney's Office to settle the federal government investigation involving NID and the Company regarding NID test kits and tests performed using those test kits. As a result of the agreement in principle in 2008, the Company recorded charges of \$75 million in discontinued operations to increase its reserve for the settlement and related matters.

On April 15, 2009, the Company finalized the resolution of the federal government investigation related to NID and entered into a final settlement agreement with the federal government. In the second quarter of 2009, the Company paid \$268 million to settle the civil allegations. The Company also entered into a five-year corporate integrity agreement with the Office of Inspector General for the United States Department of Health and Human Services. In addition, NID pled guilty to a single count of felony misbranding and paid a \$40 million fine. These second quarter payments totaling \$308 million, which had been previously reserved, were funded out of cash on-hand and available credit facilities. During the third quarter of 2009, the Company finalized separate settlement agreements with certain states and paid approximately \$6 million, which had been previously reserved for.

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Summarized financial information for the discontinued operations of NID is set forth below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--|-------------|--------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net revenues | \$ | \$ | \$ | \$ |
| Income (loss) from discontinued operations before income taxes | 280 | 148 | 295 | (2,672) |
| Income tax (expense) benefit | (546) | (60) | (613) | 1,089 |
| (Loss) income from discontinued operations, net of taxes | \$ (266) | \$ 88 | \$ (318) | \$ (1,583) |

The remaining balance sheet information related to NID was not material at June 30, 2010 and December 31, 2009.

11. BUSINESS SEGEMENT INFORMATION

Clinical testing is an essential element in the delivery of healthcare services. Physicians use clinical tests to assist in the detection, diagnosis, evaluation, monitoring and treatment of diseases and other medical conditions. Clinical testing is generally categorized as clinical laboratory testing and anatomic pathology services. Clinical laboratory testing is performed on whole blood, serum, plasma and other body fluids, such as urine, and specimens such as microbiology samples. Anatomic pathology services are principally for the detection of cancer and are performed on tissues, such as biopsies, and other samples, such as human cells. Customers of the clinical testing business include patients, physicians, hospitals, employers, governmental institutions and other commercial clinical laboratories. The clinical testing business accounted for greater than 90% of net revenues from continuing operations in 2010 and 2009.

All other operating segments include the Company's non-clinical testing businesses and consist of its risk assessment services, clinical trials testing, healthcare information technology and diagnostics products businesses. The Company's risk assessment business provides underwriting support services to the life insurance industry including teleunderwriting, paramedical examinations, laboratory testing and medical record retrieval. The Company's clinical trials testing business provides clinical testing performed in connection with clinical research trials on new drugs and vaccines. The Company's healthcare information technology business is a developer and integrator of clinical connectivity and data management solutions for healthcare organizations, physicians and clinicians. The Company's diagnostics products business manufactures and markets diagnostic test kits.

On April 19, 2006, the Company decided to discontinue NID's operations and results of operations for NID have been classified as discontinued operations for all periods presented (see Note 10).

At June 30, 2010, substantially all of the Company's services are provided within the United States, and substantially all of the Company's assets are located within the United States.

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 (in thousands, unless otherwise indicated)
 (unaudited)

The following table is a summary of segment information for the three and six months ended June 30, 2010 and 2009. Segment asset information is not presented since it is not used by the chief operating decision maker at the operating segment level. Operating earnings (loss) of each segment represents net revenues less directly identifiable expenses to arrive at operating income for the segment. General management and administrative corporate expenses, including amortization of intangible assets, are included in general corporate expenses below. The accounting policies of the segments are the same as those of the Company as set forth in Note 2 to the Consolidated Financial Statements contained in the Company's 2009 Annual Report on Form 10-K and Note 2 to the interim consolidated financial statements.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------------|------------------------------|--------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net revenues: | | | | |
| Clinical laboratory testing business | \$ 1,715,112 | \$ 1,742,292 | \$ 3,372,179 | \$ 3,405,924 |
| All other operating segments | 159,615 | 159,526 | 308,051 | 303,900 |
| Total net revenues | \$ 1,874,727 | \$ 1,901,818 | \$ 3,680,230 | \$ 3,709,824 |
| Operating earnings (loss): | | | | |
| Clinical laboratory testing business | \$ 390,216 | \$ 393,524 | \$ 731,101 | \$ 736,935 |
| All other operating segments | 16,944 | 20,302 | 18,506 | 33,165 |
| General corporate expenses | (41,266) | (54,451) | (85,151) | (89,662) |
| Total operating income | 365,894 | 359,375 | 664,456 | 680,438 |
| Non-operating expenses, net | (36,101) | (37,559) | (58,080) | (71,106) |
| Income from continuing operations before income taxes | | | | |
| | 329,793 | 321,816 | 606,376 | 609,332 |
| Income tax expense | 125,651 | 123,535 | 231,029 | 233,724 |
| Income from continuing operations | 204,142 | 198,281 | 375,347 | 375,608 |
| (Loss) income from discontinued operations, net of taxes | (266) | 88 | (318) | (1,583) |
| Net income | 203,876 | 198,369 | 375,029 | 374,025 |
| Less: Net income attributable to noncontrolling interests | 9,261 | 10,169 | 17,966 | 18,723 |
| Net income attributable to Quest Diagnostics | \$ 194,615 | \$ 188,200 | \$ 357,063 | \$ 355,302 |

12. SUMMARIZED FINANCIAL INFORMATION

The Company's Senior Notes due 2010, Senior Notes due 2011, Senior Notes due 2015, Senior Notes due 2017, Senior Notes due 2020, Senior Notes due 2037 and Senior Notes due 2040 are fully and unconditionally guaranteed, jointly and severally, by the Subsidiary Guarantors. With the exception of Quest Diagnostics Receivables Incorporated (QDRI) (see paragraph below), the non-guarantor subsidiaries are primarily foreign subsidiaries and less than wholly-owned subsidiaries.

In conjunction with the Company's secured receivables credit facility, the Company maintains a wholly-owned non-guarantor subsidiary, QDRI. The Company and certain of its Subsidiary Guarantors transfer certain domestic receivables to QDRI. QDRI utilizes the transferred receivables to collateralize borrowings under the Company's secured receivables credit facility. The Company and the Subsidiary Guarantors

provide collection services to QDRI. QDRI uses cash collections principally to purchase new receivables from the Company and the Subsidiary Guarantors.

QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
(in thousands, unless otherwise indicated)
(unaudited)

The following condensed consolidating financial data illustrates the composition of the combined guarantors. Investments in subsidiaries are accounted for by the parent using the equity method for purposes of the supplemental consolidating presentation. Earnings (losses) of subsidiaries are therefore reflected in the parent's investment accounts and earnings. The principal elimination entries relate to investments in subsidiaries and intercompany balances and transactions.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
 (in thousands, unless otherwise indicated)
 (unaudited)

Condensed Consolidating Statement of Operations
 Three Months Ended June 30, 2010

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|---------------------|
| Net revenues | \$ 218,419 | \$ 1,540,722 | \$ 181,373 | \$ (65,787) | \$ 1,874,727 |
| Operating costs and expenses: | | | | | |
| Cost of services | 129,236 | 886,783 | 62,952 | | 1,078,971 |
| Selling, general and administrative | 21,273 | 312,465 | 93,236 | (7,562) | 419,412 |
| Amortization of intangible assets | 18 | 7,601 | 1,651 | | 9,270 |
| Royalty (income) expense | (105,316) | 105,316 | | | |
| Other operating (income) expense, net | (1,346) | 233 | 2,293 | | 1,180 |
| Total operating costs and expenses | 43,865 | 1,312,398 | 160,132 | (7,562) | 1,508,833 |
| Operating income | 174,554 | 228,324 | 21,241 | (58,225) | 365,894 |
| Non-operating (expense) income, net | (39,974) | (54,940) | 588 | 58,225 | (36,101) |
| Income from continuing operations before taxes | 134,580 | 173,384 | 21,829 | | 329,793 |
| Income tax expense | 52,577 | 67,331 | 5,743 | | 125,651 |
| Income from continuing operations | 82,003 | 106,053 | 16,086 | | 204,142 |
| Loss from discontinued operations, net of taxes | | (266) | | | (266) |
| Equity earnings from subsidiaries | 112,612 | | | (112,612) | |
| Net income | 194,615 | 105,787 | 16,086 | (112,612) | 203,876 |
| Less: Net income attributable to noncontrolling interests | | | 9,261 | | 9,261 |
| Net income attributable to Quest Diagnostics | \$ 194,615 | \$ 105,787 | \$ 6,825 | \$ (112,612) | \$ 194,615 |

Condensed Consolidating Statement of Operations
 Three Months Ended June 30, 2009

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|-------------------------------------|---------------|----------------------------------|--|---------------------|---------------------|
| Net revenues | \$ 230,634 | \$ 1,560,418 | \$ 198,806 | \$ (88,040) | \$ 1,901,818 |
| Operating costs and expenses: | | | | | |
| Cost of services | 144,405 | 894,932 | 60,875 | | 1,100,212 |
| Selling, general and administrative | 51,704 | 309,371 | 95,337 | (7,656) | 448,756 |
| Amortization of intangible assets | 21 | 7,777 | 1,579 | | 9,377 |
| Royalty (income) expense | (104,117) | 104,117 | | | |
| Other operating income, net | (15,217) | (395) | (290) | | (15,902) |

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| | | | | | |
|---|------------|------------|-----------|--------------|------------|
| Total operating costs and expenses | 76,796 | 1,315,802 | 157,501 | (7,656) | 1,542,443 |
| Operating income | 153,838 | 244,616 | 41,305 | (80,384) | 359,375 |
| Non-operating (expense) income, net | (48,829) | (73,781) | 4,667 | 80,384 | (37,559) |
| Income from continuing operations before taxes | 105,009 | 170,835 | 45,972 | | 321,816 |
| Income tax expense | 41,069 | 68,488 | 13,978 | | 123,535 |
| Income from continuing operations | 63,940 | 102,347 | 31,994 | | 198,281 |
| Income from discontinued operations, net of taxes | | 88 | | | 88 |
| Equity earnings from subsidiaries | 124,260 | | | (124,260) | |
| Net income | 188,200 | 102,435 | 31,994 | (124,260) | 198,369 |
| Less: Net income attributable to noncontrolling interests | | | 10,169 | | 10,169 |
| Net income attributable to Quest Diagnostics | \$ 188,200 | \$ 102,435 | \$ 21,825 | \$ (124,260) | \$ 188,200 |

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
 (in thousands, unless otherwise indicated)
 (unaudited)

Condensed Consolidating Statement of Operations
 Six Months Ended June 30, 2010

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|---------------------|
| Net revenues | \$ 429,640 | \$ 3,023,312 | \$ 373,709 | \$ (146,431) | \$ 3,680,230 |
| Operating costs and expenses: | | | | | |
| Cost of services | 251,823 | 1,766,570 | 126,951 | | 2,145,344 |
| Selling, general and administrative | 44,351 | 626,583 | 194,104 | (14,893) | 850,145 |
| Amortization of intangible assets | 35 | 15,232 | 3,362 | | 18,629 |
| Royalty (income) expense | (206,808) | 206,808 | | | |
| Other operating (income) expense, net | (321) | 466 | 1,511 | | 1,656 |
| Total operating costs and expenses | 89,080 | 2,615,659 | 325,928 | (14,893) | 3,015,774 |
| Operating income | 340,560 | 407,653 | 47,781 | (131,538) | 664,456 |
| Non-operating (expense) income, net | (70,533) | (121,385) | 2,300 | 131,538 | (58,080) |
| Income from continuing operations before taxes | 270,027 | 286,268 | 50,081 | | 606,376 |
| Income tax expense | 104,062 | 113,078 | 13,889 | | 231,029 |
| Income from continuing operations | 165,965 | 173,190 | 36,192 | | 375,347 |
| Loss from discontinued operations, net of taxes | | (318) | | | (318) |
| Equity earnings from subsidiaries | 191,098 | | | (191,098) | |
| Net income | 357,063 | 172,872 | 36,192 | (191,098) | 375,029 |
| Less: Net income attributable to noncontrolling interests | | | 17,966 | | 17,966 |
| Net income attributable to Quest Diagnostics | \$ 357,063 | \$ 172,872 | \$ 18,226 | \$ (191,098) | \$ 357,063 |

Condensed Consolidating Statement of Operations
 Six Months Ended June 30, 2009

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|---------------------------------------|---------------|----------------------------------|--|---------------------|---------------------|
| Net revenues | \$ 440,686 | \$ 3,056,335 | \$ 370,365 | \$ (157,562) | \$ 3,709,824 |
| Operating costs and expenses: | | | | | |
| Cost of services | 271,368 | 1,763,019 | 119,314 | | 2,153,701 |
| Selling, general and administrative | 84,376 | 616,341 | 187,314 | (14,974) | 873,057 |
| Amortization of intangible assets | 47 | 15,625 | 2,710 | | 18,382 |
| Royalty (income) expense | (200,457) | 200,457 | | | |
| Other operating (income) expense, net | (16,196) | (184) | 626 | | (15,754) |

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| | | | | | |
|---|------------|------------|-----------|--------------|------------|
| Total operating costs and expenses | 139,138 | 2,595,258 | 309,964 | (14,974) | 3,029,386 |
| Operating income | 301,548 | 461,077 | 60,401 | (142,588) | 680,438 |
| Non-operating (expense) income, net | (90,635) | (130,245) | 7,186 | 142,588 | (71,106) |
| Income from continuing operations before taxes | 210,913 | 330,832 | 67,587 | | 609,332 |
| Income tax expense | 82,359 | 132,282 | 19,083 | | 233,724 |
| Income from continuing operations | 128,554 | 198,550 | 48,504 | | 375,608 |
| Loss from discontinued operations, net of taxes | | (1,583) | | | (1,583) |
| Equity earnings from subsidiaries | 226,748 | | | (226,748) | |
| Net income | 355,302 | 196,967 | 48,504 | (226,748) | 374,025 |
| Less: Net income attributable to noncontrolling interests | | | 18,723 | | 18,723 |
| Net income attributable to Quest Diagnostics | \$ 355,302 | \$ 196,967 | \$ 29,781 | \$ (226,748) | \$ 355,302 |

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
 (in thousands, unless otherwise indicated)
 (unaudited)

Condensed Consolidating Balance Sheet
 June 30, 2010

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|---|------------------|----------------------------------|--|---------------------|---------------------|
| Assets | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | \$ 386,621 | \$ 11,649 | \$ 49,618 | \$ | \$ 447,888 |
| Accounts receivable, net | 26,185 | 132,217 | 711,241 | | 869,643 |
| Other current assets | 71,816 | 158,993 | 99,207 | (16,203) | 313,813 |
| | <u>484,622</u> | <u>302,859</u> | <u>860,066</u> | <u>(16,203)</u> | <u>1,631,344</u> |
| Total current assets | 484,622 | 302,859 | 860,066 | (16,203) | 1,631,344 |
| Property, plant and equipment, net | 170,348 | 600,892 | 32,950 | | 804,190 |
| Goodwill and intangible assets, net | 156,126 | 5,294,552 | 412,307 | | 5,862,985 |
| Intercompany receivable (payable) | 351,019 | 14,896 | (365,915) | | |
| Investment in subsidiaries | 5,952,245 | | | (5,952,245) | |
| Other assets | 196,817 | 10,364 | 57,675 | (81,583) | 183,273 |
| | <u>7,311,177</u> | <u>6,223,563</u> | <u>997,083</u> | <u>(6,050,031)</u> | <u>8,481,792</u> |
| Total assets | \$ 7,311,177 | \$ 6,223,563 | \$ 997,083 | \$ (6,050,031) | \$ 8,481,792 |
| Liabilities and Stockholders' Equity | | | | | |
| Current liabilities: | | | | | |
| Accounts payable and accrued expenses | \$ 617,901 | \$ 171,906 | \$ 50,771 | \$ (16,203) | \$ 824,375 |
| Current portion of long-term debt | 165,977 | 2,946 | 2,205 | | 171,128 |
| | <u>783,878</u> | <u>174,852</u> | <u>52,976</u> | <u>(16,203)</u> | <u>995,503</u> |
| Total current liabilities | 783,878 | 174,852 | 52,976 | (16,203) | 995,503 |
| Long-term debt | 2,499,029 | 147,535 | 327,275 | | 2,973,839 |
| Other liabilities | 103,938 | 497,323 | 45,884 | (81,583) | 565,562 |
| Stockholders' equity: | | | | | |
| Quest Diagnostics stockholders' equity | 3,924,332 | 5,403,853 | 548,392 | (5,952,245) | 3,924,332 |
| Noncontrolling interests | | | 22,556 | | 22,556 |
| | <u>3,924,332</u> | <u>5,403,853</u> | <u>570,948</u> | <u>(5,952,245)</u> | <u>3,946,888</u> |
| Total stockholders' equity | 3,924,332 | 5,403,853 | 570,948 | (5,952,245) | 3,946,888 |
| | <u>7,311,177</u> | <u>6,223,563</u> | <u>997,083</u> | <u>(6,050,031)</u> | <u>8,481,792</u> |
| Total liabilities and stockholders' equity | \$ 7,311,177 | \$ 6,223,563 | \$ 997,083 | \$ (6,050,031) | \$ 8,481,792 |

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
 (in thousands, unless otherwise indicated)
 (unaudited)

Condensed Consolidating Balance Sheet
 December 31, 2009

| | Parent | Subsidiary Guarantors | Non- Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---------------------|--------------------------|-----------------------------------|-----------------------|---------------------|
| Assets | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | \$ 464,958 | \$ 17,457 | \$ 51,841 | \$ | \$ 534,256 |
| Accounts receivable, net | 3,461 | 156,102 | 667,780 | | 827,343 |
| Other current assets | 64,354 | 169,233 | 99,109 | (14,870) | 317,826 |
| | <u>532,773</u> | <u>342,792</u> | <u>818,730</u> | <u>(14,870)</u> | <u>1,679,425</u> |
| Total current assets | 532,773 | 342,792 | 818,730 | (14,870) | 1,679,425 |
| Property, plant and equipment, net | 181,790 | 607,951 | 36,205 | | 825,946 |
| Goodwill and intangible assets, net | 153,145 | 5,308,433 | 446,031 | | 5,907,609 |
| Intercompany receivable (payable) | 471,421 | (137,227) | (334,194) | | |
| Investment in subsidiaries | 5,790,333 | | | (5,790,333) | |
| Other assets | 194,990 | 11,428 | 49,970 | (105,725) | 150,663 |
| | <u>\$ 7,324,452</u> | <u>\$ 6,133,377</u> | <u>\$ 1,016,742</u> | <u>\$ (5,910,928)</u> | <u>\$ 8,563,643</u> |
| Total assets | \$ 7,324,452 | \$ 6,133,377 | \$ 1,016,742 | \$ (5,910,928) | \$ 8,563,643 |
| Liabilities and Stockholders' Equity | | | | | |
| Current liabilities: | | | | | |
| Accounts payable and accrued expenses | \$ 641,964 | \$ 239,417 | \$ 22,194 | \$ (14,870) | \$ 888,705 |
| Current portion of long-term debt | 165,661 | 2,436 | 2,410 | | 170,507 |
| | <u>807,625</u> | <u>241,853</u> | <u>24,604</u> | <u>(14,870)</u> | <u>1,059,212</u> |
| Total current liabilities | 807,625 | 241,853 | 24,604 | (14,870) | 1,059,212 |
| Long-term debt | 2,430,806 | 146,556 | 359,430 | | 2,936,792 |
| Other liabilities | 96,382 | 513,987 | 51,531 | (105,725) | 556,175 |
| Stockholders' equity: | | | | | |
| Quest Diagnostics stockholders' equity | 3,989,639 | 5,230,981 | 559,352 | (5,790,333) | 3,989,639 |
| Noncontrolling interests | | | 21,825 | | 21,825 |
| | <u>3,989,639</u> | <u>5,230,981</u> | <u>581,177</u> | <u>(5,790,333)</u> | <u>4,011,464</u> |
| Total stockholders' equity | 3,989,639 | 5,230,981 | 581,177 | (5,790,333) | 4,011,464 |
| | <u>\$ 7,324,452</u> | <u>\$ 6,133,377</u> | <u>\$ 1,016,742</u> | <u>\$ (5,910,928)</u> | <u>\$ 8,563,643</u> |
| Total liabilities and stockholders' equity | \$ 7,324,452 | \$ 6,133,377 | \$ 1,016,742 | \$ (5,910,928) | \$ 8,563,643 |

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
 (in thousands, unless otherwise indicated)
 (unaudited)

Condensed Consolidating Statement of Cash Flows
 Six Months Ended June 30, 2010

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|---------------------|
| Cash flows from operating activities: | | | | | |
| Net income | \$ 357,063 | \$ 172,872 | \$ 36,192 | \$ (191,098) | \$ 375,029 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | | |
| Depreciation and amortization | 24,331 | 93,907 | 8,069 | | 126,307 |
| Provision for doubtful accounts | 3,006 | 24,669 | 120,728 | | 148,403 |
| Other, net | (131,368) | (6,194) | (17,401) | 191,098 | 36,135 |
| Changes in operating assets and liabilities | 82,079 | (196,396) | (123,173) | | (237,490) |
| Net cash provided by operating activities | 335,111 | 88,858 | 24,415 | | 448,384 |
| Net cash provided by (used in) investing activities | 11,063 | (68,458) | (2,763) | (31,886) | (92,044) |
| Net cash used in financing activities | (424,511) | (26,208) | (23,875) | 31,886 | (442,708) |
| Net change in cash and cash equivalents | (78,337) | (5,808) | (2,223) | | (86,368) |
| Cash and cash equivalents, beginning of period | 464,958 | 17,457 | 51,841 | | 534,256 |
| Cash and cash equivalents, end of period | \$ 386,621 | \$ 11,649 | \$ 49,618 | \$ | \$ 447,888 |

Condensed Consolidating Statement of Cash Flows
 Six Months Ended June 30, 2009

| | <u>Parent</u> | <u>Subsidiary Guarantors</u> | <u>Non- Guarantor Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|---|---------------|----------------------------------|--|---------------------|---------------------|
| Cash flows from operating activities: | | | | | |
| Net income | \$ 355,302 | \$ 196,967 | \$ 48,504 | \$ (226,748) | \$ 374,025 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | | |
| Depreciation and amortization | 28,105 | 94,480 | 7,462 | | 130,047 |
| Provision for doubtful accounts | 3,004 | 34,322 | 128,098 | | 165,424 |
| Other, net | (170,732) | 45,361 | (3,455) | 226,748 | 97,922 |
| Changes in operating assets and liabilities | (80,445) | (289,358) | (134,059) | | (503,862) |
| Net cash provided by operating activities | 135,234 | 81,772 | 46,550 | | 263,556 |
| Net cash provided by (used in) investing activities | 167,271 | (62,224) | (1,056) | (198,067) | (94,076) |
| Net cash used in financing activities | (465,447) | (11,756) | (24,996) | 198,067 | (304,132) |
| Net change in cash and cash equivalents | (162,942) | 7,792 | 20,498 | | (134,652) |

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| | | | | |
|--|------------------|------------------|------------------|-------------------|
| Cash and cash equivalents, beginning of period | <u>218,565</u> | <u>6,715</u> | <u>28,666</u> | <u>253,946</u> |
| Cash and cash equivalents, end of period | <u>\$ 55,623</u> | <u>\$ 14,507</u> | <u>\$ 49,164</u> | <u>\$ 119,294</u> |

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

Healthcare Reform

In March 2010, U.S. federal legislation was enacted which is likely to have a significant impact on, among other things, access to and the cost of healthcare in the United States. The legislation provides for extensive health insurance reforms and expands coverage to approximately 32 million Americans, which will result in expanded access to healthcare. In addition, the legislation eliminates patient cost-sharing for certain prevention and wellness benefits for plans that are not grandfathered. We believe these changes will benefit our industry by leading to increased utilization of our services.

These benefits are expected to be partially offset by provisions of the legislation aimed at reducing the overall cost of healthcare. Impacting laboratories specifically, the legislation provides for annual reductions in the Medicare clinical laboratory fee schedule of 1.75% for five years beginning in 2011 and includes a productivity adjustment which reduces the CPI market basket update beginning in 2011. In 2009, approximately 12% of our consolidated revenues were reimbursed by Medicare under the clinical laboratory fee schedule. The legislation also imposes an excise tax on the seller for the sale of certain medical devices in the United States, including those purchased and used by laboratories, beginning in 2013.

In addition, the legislation is focused on reducing the growth of healthcare costs. The legislation establishes the Independent Payment Advisory Board, which will be responsible, beginning in 2014, annually to submit proposals aimed at reducing Medicare cost growth while preserving quality. These proposals automatically will be implemented unless Congress enacts alternative proposals that achieve the same savings targets. Further, the legislation calls for a Center for Medicare and Medicaid Innovation that will examine alternative payment methodologies and conduct demonstration programs.

We believe that the legislation will be a net positive for our industry over the long term due to expanded coverage and the elimination of patient cost-sharing for certain prevention and wellness benefits, and that we are well positioned to respond to the evolving healthcare environment and related market forces.

In addition to the healthcare reform legislation, in June 2010, the President signed into law an extension to delay until November 30, 2010 a potential 21.2% decrease in the Medicare fee schedule for pathology and other physician services performed for patients and billed under Part B of the Medicare program. It is currently not clear if legislation will be passed to permanently eliminate this potential fee decrease. In 2009, approximately 3% of our consolidated revenues were reimbursed based on this fee schedule.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions and select accounting policies that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

While many operational aspects of our business are subject to complex federal, state and local regulations, the accounting for our business is generally straightforward, with net revenues primarily recognized upon completion of the testing process. Our revenues are primarily comprised of a high volume of relatively low dollar transactions, and about one-half of total operating costs and expenses consist of employee compensation and benefits. Due to the nature of our business, several of our accounting policies involve significant estimates and judgments. These accounting policies have been described in our Annual Report on Form 10-K for the year ended December 31, 2009.

Results of Operations

Our clinical testing business currently represents our one reportable business segment. In both 2010 and 2009, our clinical testing business accounted for greater than 90% of net revenues. Our other operating segments consist of our risk assessment services, clinical trials testing, healthcare information technology, and diagnostic products businesses. Our business segment information is disclosed in Note 11 to the interim consolidated financial statements.

Three and Six Months Ended June 30, 2010 Compared with Three and Six Months Ended June 30, 2009

Continuing Operations

Income from continuing operations for the three months ended June 30, 2010 was \$195 million, or \$1.07 per diluted share, compared to \$188 million, or \$1.00 per diluted share, in 2009. Income from continuing operations for the six months ended June 30, 2010 was \$357 million, or \$1.96 per diluted share, compared to \$357 million, or \$1.89 per diluted share, in 2009. The increase in income from continuing operations for the three months ended June 30, 2010 compared to the prior year period was principally driven by actions we have taken to adjust our cost structure in response to lower testing volume, reduced costs for performance-based compensation, improved experience associated with professional liability claims and continued progress in reducing bad debt expense. Lower share counts, resulting from share repurchases, contributed to the earnings per share improvement for both periods.

Results for the six months ended June 30, 2010 include a first quarter charge of \$17.3 million, or \$0.06 per diluted share, principally associated with workforce reductions. Of these costs, \$4.5 million and \$12.8 million, respectively, were included in cost of services and selling, general and administrative expenses. In addition, we estimate that the impact of severe weather in the first quarter of 2010 adversely affected the comparison of operating income for the six months ended June 30, 2010 to the prior year period by \$14.3 million, or \$0.05 per diluted share.

Results for the three and six months ended June 30, 2009 include a \$15.5 million gain, or \$0.05 per diluted share, associated with an insurance settlement for storm related losses, offset by a \$6.3 million charge, or \$0.02 per diluted share, associated with the early extinguishment of debt and a \$7.0 million charge, or \$0.02 per diluted share, associated with the write-down of an investment.

Net Revenues

Net revenues for the three months ended June 30, 2010 were \$1.9 billion and reflect a decrease of 1.4% from the prior year level. Net revenues for the six months ended June 30, 2010 were \$3.7 billion and reflect a decrease of 0.8% from the prior year level.

For the second quarter of 2010, revenues for our clinical testing business, which accounts for over 90% of our net revenues, decreased by 1.6% compared to the prior year. Clinical testing volume, measured by the number of requisitions, decreased 1.3% for the quarter. We believe that clinical testing volume was adversely affected primarily by a general slowdown in physician office visits. Revenue per requisition decreased 0.3% for the three months ended June 30, 2010. Revenue per requisition continues to benefit from an increased mix of gene-based and esoteric testing and increases in the number of tests ordered per requisition. This benefit has been offset by the 1.9% Medicare fee schedule decrease, which went into effect on January 1, 2010 and served to reduce revenue per requisition by 0.5%; changes in business and payer mix, including an increase in drugs-of-abuse testing, and a reduction in anatomic pathology testing; and pricing changes in connection with several large contract extensions.

For the six months ended June 30, 2010, revenues for our clinical testing business were 1.0% below the prior year level. Clinical testing volume, measured by the number of requisitions, decreased 1.9%. We believe that clinical testing volume was adversely affected primarily by a general slowdown in physician office visits and severe weather in the first quarter of 2010. Revenue per requisition increased 1.0% for the six months ended June 30, 2010, with the increase primarily driven by an increased mix of gene-based and esoteric testing and increases in the number of tests ordered by requisition, partially offset by the 1.9% Medicare fee schedule decrease, which went into effect on January 1, 2010 and served to reduce revenue per requisition by 0.5%; business and payer mix changes, including an increase in drugs-of-abuse testing and a decrease in anatomic pathology testing; and pricing changes in connection with several large contract extensions.

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Our businesses other than clinical laboratory testing accounted for approximately 8% of our net revenues for the three and six months ended June 30, 2010. These businesses include our risk assessment services, clinical trials testing, healthcare information technology, and diagnostic products businesses. These businesses contain most of our international operations and, in the aggregate, reported revenue growth for the three and six months ended June 30, 2010 of 0.1% and 1.4%, respectively, above the prior year periods, with the increases principally driven by the impact of foreign exchange rates.

Operating Costs and Expenses

Total operating costs and expenses for the three months ended June 30, 2010 decreased \$33.6 million, compared to the second quarter of 2009, and decreased as a percentage of net revenues to 80.5% compared to 81.1% in 2009. Total operating costs and expenses for the six months ended June 30, 2010 decreased by \$13.6 million from the prior year period and increased as a percentage of net revenues to 81.9% compared to 81.7% in 2009. Actions to adjust our cost structure in response to lower testing volume, reduced costs for performance-based compensation, and improved experience associated with professional liability claims and continued progress in reducing bad debt expense all served to lower total operating costs as a percentage of net revenue for the three months ended June 30, 2010.

Lower testing volume in our clinical testing business, including the impact of severe weather in the first quarter of 2010, and charges associated with actions we have taken to adjust our cost structure served to increase total operating costs as a percentage of net revenues for the six months ended June 30, 2010. During the first quarter of 2010, we recorded \$17.3 million of pre-tax charges, principally associated with workforce reductions, of which \$4.5 million was recorded in cost of services and \$12.8 million was recorded in selling, general and administrative expenses. In addition, operating costs for the three and six months ended June 30, 2009 include a \$15.5 million gain related to an insurance settlement for storm related losses, which served to decrease total operating costs as a percentage of net revenues for the three and six months ended June 30, 2009.

Also, year-over-year comparisons for the three and six months ended June 30, 2010 were favorably impacted by approximately \$8 million and \$4 million, respectively, associated with investment gains and losses on investments in our supplemental deferred compensation plans. Under our supplemental deferred compensation plans, employee compensation deferrals, together with Company matching contributions, are invested in a variety of investments held in trusts. Gains and losses associated with the investments are recorded in earnings within other expense, net. A corresponding and offsetting adjustment is also recorded to the deferred compensation obligation to reflect investment gains and losses earned by the employee. Such adjustments to the deferred compensation obligation are recorded in earnings principally within selling, general and administrative expenses and offset the amount of investment gains and losses recorded in other expense, net. Results for the three and six months ended June 30, 2010 included a reduction in operating costs of \$3.9 million and \$1.4 million, respectively, representing a decrease in the deferred compensation obligation to reflect investment losses incurred by employees participating in our deferred compensation plans. Results for the three and six months ended June 30, 2009 included an increase in operating costs of \$4.3 million and \$2.5 million, respectively, representing an increase in the deferred compensation obligation to reflect investment gains earned by employees participating in our deferred compensation plans.

Cost of services, which includes the costs of obtaining, transporting and testing specimens, was 57.6% of net revenues for the three months ended June 30, 2010, decreasing from 57.9% of net revenues in the prior year period. For the six months ended June 30, 2010, cost of services, as a percentage of net revenues, was 58.3%, increasing from 58.1% of net revenues in the prior year period. The improvement in cost of services as a percentage of net revenues for the three months ended June 30, 2010 primarily reflects actions we have taken to adjust our cost structure in response to lower testing volumes, reduced performance-based compensation, and improved experience associated with professional liability claims. The increase for the six months ended June 30, 2010 primarily reflects lower testing volume in our clinical testing business, including the impact of severe weather in the first quarter of 2010, and charges associated with workforce reductions in response to lower testing volume, partially offset by reduced performance-based compensation and improved experience associated with professional liability claims.

Selling, general and administrative expenses, which include the costs of the sales force, billing operations, bad debt expense, and general management and administrative support was 22.4% of net revenues for the three months ended June 30, 2010, compared to 23.6% in the prior year period. For the six months ended June 30, 2010, selling, general and administrative expenses, as a percentage of net revenues, was 23.1% compared to 23.5% in the prior year period. The

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improvement in selling, general, and administrative expenses as a percentage of net revenues for the three months ended June 30, 2010 primarily reflects the impact of actions we have taken to adjust our cost structure in response to lower testing volume, reduced performance-based compensation and improvements in bad debt expense. The improvement for the six months ended June 30, 2010 primarily reflects the impact of cost reduction measures to adjust our cost structure in response to lower testing volume, reduced performance-based compensation and improvements in bad debt expense, partially offset by charges associated with workforce reductions. In addition, year-over-year comparisons of selling, general and administrative expenses as a percentage of net revenues for the three and six months ended June 30, 2010 were favorably impacted by approximately 40 basis points and 10 basis points, respectively, associated with investment gains and losses earned by employees on assets held in trusts under our deferred compensation plans discussed earlier.

For the three months ended June 30, 2010, bad debt expense was 3.8% compared to 4.4% of net revenues, in the prior year period. For the six months ended June 30, 2010, bad debt expense was 4.0% compared to 4.5% of net revenues in the prior year period. Continued progress in our billing and collection processes has resulted in improvements in bad debt, days sales outstanding and the cost of our billing operation. With our disciplined approach, we expect to see continued strong performance in our billing and collection metrics, despite a slow economy.

Other operating expense (income), net represents miscellaneous income and expense items related to operating activities including gains and losses associated with the disposal of operating assets and provisions for restructurings and other special charges. For the three and six months ended June 30, 2009, other operating expense (income), net includes a \$15.5 million gain associated with an insurance settlement for storm related losses.

Operating Income

Operating income for the three months ended June 30, 2010 was \$366 million, or 19.5% of net revenues, compared to \$359 million, or 18.9% of net revenues, in the prior year period. For the six months ended June 30, 2010, operating income was \$664 million, or 18.1% of net revenues, compared to \$680 million, or 18.3% of net revenues in the prior year period. For the three months ended June 30, 2010, the improvement in operating margin primarily reflects the impact of actions we have taken to adjust our cost structure in response to lower testing volume. In addition, reduced costs for performance-based compensation, improved experience associated with professional liability claims and continued progress in reducing bad debt expense all served to expand operating income as a percentage of net revenues. In addition, year-over-year comparisons were favorably impacted by approximately \$8 million, or approximately 40 basis points, associated with investment gains and losses earned by employees on assets held in trusts under our deferred compensation plans. For the six months ended June 30, 2010, the decrease in operating income as a percentage of net revenues primarily reflects the impact of lower testing volume in our clinical testing business, including the estimated impact of severe weather in the first quarter of 2010, and charges associated with workforce reductions, partially offset by actions taken to adjust our cost structure reduced performance-based compensation, improved experience associated with professional liability claims and bad debt expense. The estimated impact of severe weather combined with charges associated with actions we have taken to adjust our cost structure adversely impacted the year-over-year change in operating income as a percentage of net revenues by 90 basis points, compared to the prior year-to-date period. In addition, the year-over-year change in operating income as a percentage of net revenues for the three and six months ended June 30, 2009 is also adversely impacted by a \$15.5 million gain related to an insurance settlement for storm related losses, which served to increase operating income as a percentage of net revenues for the three and six months ended June 30, 2009. Also, year-over-year comparisons were favorably impacted by approximately \$4 million, or approximately 10 basis points, associated with investment gains and losses earned by employees on assets held in trusts under our deferred compensation plans.

Other Income (Expense)

Interest expense, net for the three and six months ended June 30, 2010 decreased \$0.5 million and \$4 million, respectively, compared to the prior year periods. These decreases were primarily due to lower interest rates on our variable-rate debt.

Other expense, net represents miscellaneous income and expense items related to non-operating activities, such as gains and losses associated with investments and other non-operating assets. For the three months ended June 30, 2010, other expense, net includes losses of \$3.9 million associated with investments held in trusts pursuant to our supplemental deferred compensation plans and a loss of \$3.3 million from other investments. For the six months

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ended June 30, 2010, other expense, net reflects net losses of \$1.4 million associated with investments held in trusts pursuant to our supplemental deferred compensation plans and a net gain of \$0.7 million from other investments.

For the three and six months ended June 30, 2009, other expense, net includes gains of \$4.3 million and \$2.5 million, respectively, associated with investments held in trusts pursuant to our supplemental deferred compensation plans. Additionally, for the three and six months ended June 30, 2009, other expense, net includes a charge of \$7.0 million associated with the write-down of an investment and a charge of \$6.3 million associated with the early extinguishment of debt.

Discontinued Operations

Results of discontinued operations, net of taxes, for the three months ended June 30, 2010 and 2009, were a loss of \$0.3 million and income of \$0.1 million, respectively, with no impact on diluted earnings per share. For the six months ended June 30, 2010 and 2009, loss from discontinued operations, net of taxes was \$0.3 million, with no earnings per share impact, and \$1.6 million or \$0.01 per diluted share, respectively. See Note 10 to the interim consolidated financial statements for further details.

Quantitative and Qualitative Disclosures About Market Risk

We address our exposure to market risks, principally the market risk of changes in interest rates, through a controlled program of risk management that includes the use of derivative financial instruments. We do not hold or issue derivative financial instruments for trading purposes. We believe that our exposures to foreign exchange impacts and changes in commodities prices are not material to our consolidated financial condition or results of operations.

At June 30, 2010 and December 31, 2009, the fair value of our debt was estimated at approximately \$3.3 billion, using quoted market prices and yields for the same or similar types of borrowings, taking into account the underlying terms of the debt instruments. At June 30, 2010 and December 31, 2009, the estimated fair value exceeded the carrying value of the debt by \$164 million and \$151 million, respectively. A hypothetical 10% increase in interest rates (representing 47 basis points at June 30, 2010 and 46 basis points at December 31, 2009) would potentially reduce the estimated fair value of our debt by \$90 million and \$96 million at June 30, 2010 and December 31, 2009, respectively.

Borrowings under our senior unsecured revolving credit facility, our secured receivables credit facility and our term loan due May 2012 are subject to variable interest rates. Interest on our secured receivables credit facility is based on rates that are intended to approximate commercial paper rates for highly-rated issuers. Interest rates on our senior unsecured revolving credit facility and term loan due May 2012 are subject to a pricing schedule that can fluctuate based on changes in our credit ratings. As such, our borrowing costs under these credit arrangements will be subject to both fluctuations in interest rates and changes in our credit ratings. As of June 30, 2010, the borrowing rates under these credit facilities were: for our secured receivables credit facility, 1.5%; for our senior unsecured credit facility, LIBOR plus 0.40%; and for our term loan due May 2012, LIBOR plus 0.40%. At June 30, 2010, the weighted average LIBOR was 0.31%. At June 30, 2010, there was \$742 million outstanding under our term loan due May 2012, and no borrowings outstanding under our \$750 million senior unsecured revolving credit facility or our \$525 million secured receivables credit facility.

Our objective is to mitigate the variability in cash outflows that result from changes in interest rates by maintaining a balanced mix of fixed-rate and variable-rate debt obligations. In order to achieve these objectives, we have entered into interest rate swaps. Interest rate swaps involve the periodic exchange of payments without the exchange of underlying principal or notional amounts. Net payments are recognized as an adjustment to interest expense.

In November 2009, we entered into various fixed-to-variable interest rate swap agreements that effectively convert a portion of our 4.75% Senior Notes due 2020 to variable-interest rate debt based on LIBOR plus 1.33%. At June 30, 2010, the interest rate swap agreements which expire in January 2020 have a notional amount totaling \$350 million. The fixed-to-variable interest rate swap agreements are accounted for as fair value hedges of a portion of our outstanding 4.75% Senior Notes due 2020. Based on our net exposure to interest rate changes, a hypothetical 10% change in interest rates on our variable rate indebtedness (representing 4 basis points) would impact annual interest expense by \$0.5 million, assuming no changes to the debt outstanding at June 30, 2010.

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The fair value of the fixed-to-variable interest rate swap agreements at June 30, 2010 was an asset of \$21 million. A hypothetical 10% change in interest rates (representing 30 basis points) would potentially change the fair value of the asset of these instruments by approximately \$9 million.

For details regarding our outstanding debt, see Note 10 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2009. For details regarding our derivative financial instruments, see Note 6 to the interim consolidated financial statements.

Risk Associated with Investment Portfolio

Our investment portfolio includes equity investments in publicly held companies that are classified as available-for-sale securities and other strategic equity holdings in privately held companies. These securities are exposed to price fluctuations and are generally concentrated in the life sciences industry. The carrying values of our available-for-sale equity securities and privately held securities were \$17 million at June 30, 2010.

We regularly evaluate the fair value measurements of our equity investments to determine if losses in value are other than temporary and if an impairment loss has been incurred. The evaluation considers if the security has the ability to recover and, if so, the estimated recovery period. Other factors that are considered in this evaluation include the amount of the other-than-temporary decline and its duration, the issuer's financial condition and short-term prospects and whether the market decline was caused by overall economic conditions or conditions specific to the individual security.

We do not hedge our equity price risk. The impact of an adverse movement in equity prices on our holdings in privately held companies cannot be easily quantified, as our ability to realize returns on investments depends on, among other things, the enterprises' ability to raise additional capital or derive cash inflows from continuing operations or through liquidity events such as initial public offerings, mergers or private sales.

Liquidity and Capital Resources

Cash and Cash Equivalents

Cash and cash equivalents at June 30, 2010 totaled \$448 million compared to \$534 million at December 31, 2009. Cash and cash equivalents consist of highly liquid short-term investments. For the six months ended June 30, 2010, cash flows from operating activities of \$448 million, together with cash on-hand, were used to fund investing and financing activities of \$92 million and \$443 million, respectively. Cash and cash equivalents at June 30, 2009 totaled \$119 million compared to \$254 million at December 31, 2008. For the six months ended June 30, 2009, cash flows from operating activities of \$264 million, together with cash on-hand, were used to fund investing and financing activities of \$94 million and \$304 million, respectively.

Cash Flows from Operating Activities

Net cash provided by operating activities for the six months ended June 30, 2010 was \$448 million compared to \$264 million in the prior year period. For the six months ended June 30, 2009, cash flows from operating activities includes second quarter 2009 payments totaling \$308 million in connection with the NID settlement (see Note 10 to the interim consolidated financial statements), or \$258 million net of an associated reduction in estimated tax payments. After giving consideration to the settlement payments, net of the associated reduction in tax payments, underlying cash flows from operating activities decreased in comparison to the prior year level, primarily driven by a change in the timing of variable compensation and accrued expenses. Days sales outstanding, a measure of billing and collection efficiency, were 42 days at June 30, 2010 compared to 43 days at both June 30, 2009 and December 31, 2009.

Cash Flows from Investing Activities

Net cash used in investing activities for the six months ended June 30, 2010 and 2009 was \$92 million and \$94 million, respectively and consisted principally of capital expenditures.

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Cash Flows from Financing Activities

Net cash used in financing activities for the six months ended June 30, 2010 was \$443 million, consisting primarily of purchases of treasury stock totaling \$426 million, dividend payments of \$36 million and distributions to noncontrolling interests of \$17 million, partially offset by \$40 million in proceeds from the exercise of stock options, including related tax benefits. The \$426 million of treasury stock purchases represents 7.7 million shares of our common stock purchased at an average price of \$55.00 per share, including 4.5 million shares purchased in the first quarter at an average price of \$56.21 for \$251 million under an accelerated share repurchase transaction with a bank.

Net cash used in financing activities for the six months ended June 30, 2009 was \$304 million, consisting primarily of purchases of treasury stock totaling \$250 million, dividend payments of \$38 million and a decrease in book overdrafts of \$20 million, partially offset by \$19 million in proceeds from the exercise of stock options, including related tax benefits. The \$250 million of treasury stock purchases represents 5.6 million shares of our common stock purchased at an average price of \$44.48 per share. Cash flows from financing activities for the six months ended June 30, 2009 also included \$510 million of borrowings and \$511 million of repayments. Borrowings under our secured receivables credit facility totaled \$510 million and were used primarily to fund the NID settlement payments totaling \$308 million and retire debt of \$150 million in connection with our June 2009 debt tender. Debt repayments of \$511 million consisted primarily of the repayment of \$310 million on our secured receivables credit facility, \$174 million of our 5.125% senior notes due 2010 and \$26 million of our 7.50% senior notes due 2011.

Dividend Program

During each of the quarters of 2010 and 2009, our Board of Directors declared a quarterly cash dividend of \$0.10 per common share. On May 6, 2010, our Board of Directors declared a quarterly cash dividend per common share of \$0.10, paid on July 20, 2010. We expect to fund future dividend payments with cash flows from operations, and do not expect the dividend to have a material impact on our ability to finance future growth.

Share Repurchase Plan

In January 2010, our Board of Directors authorized \$750 million of additional share repurchases. The share repurchase authorization has no set expiration or termination date. For the three months ended June 30, 2010, we repurchased 3.3 million shares of our common stock at an average price of \$53.36 per share for \$175 million. For the six months ended June 30, 2010, we repurchased 7.7 million shares of our common stock at an average price of \$55.00 per share for \$426 million, including 4.5 million shares purchased in the first quarter at an average price of \$56.21 per share for \$251 million under an accelerated share repurchase transaction with a bank. For the three and six months ended June 30, 2010, we reissued 0.6 million shares and 1.6 million shares, respectively, for employee benefit plans. Since its inception in May 2003, we have repurchased approximately 67 million shares of our common stock at an average price of \$47.19 for \$3.2 billion under our share repurchase program. At June 30, 2010, \$324 million of share repurchase authorization remained available which we currently intend to utilize during the remainder of 2010.

Contractual Obligations and Commitments

The following table summarizes certain of our contractual obligations as of June 30, 2010:

| Contractual Obligations | Payments due by period | | | | |
|---------------------------------------|-------------------------------|------------------------------|-----------------------|-------------------|----------------------|
| | Total | Remainder of 2010 | (in thousands) | | |
| | | | 1-3 years | 3 5 years | After 5 years |
| Outstanding debt | \$ 3,116,802 | \$ 165,534 | \$ 901,268 | \$ 7,202 | \$ 2,050,000 |
| Capital lease obligations | 26,605 | 2,908 | 10,286 | 7,202 | 6,209 |
| Interest payments on outstanding debt | 1,695,100 | 66,426 | 232,005 | 322,225 | 1,074,444 |
| Operating leases | 634,019 | 94,544 | 257,647 | 126,665 | 155,163 |
| Purchase obligations | 114,150 | 26,178 | 66,592 | 17,174 | 4,206 |
| Total contractual obligations | \$ 5,586,676 | \$ 355,590 | \$ 1,467,798 | \$ 473,266 | \$ 3,290,022 |

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Interest payments on our outstanding debt have been calculated after giving effect to our interest rate swap agreements, using the interest rates as of June 30, 2010 applied to the June 30, 2010 balances, which are assumed to remain outstanding through their maturity dates.

A full description of the terms of our indebtedness and related debt service requirements and our future payments under certain of our contractual obligations is contained in Note 10 to the Consolidated Financial Statements in our 2009 Annual Report on Form 10-K. A full discussion and analysis regarding our minimum rental commitments under noncancelable operating leases and noncancelable commitments to purchase products or services at December 31, 2009 is contained in Note 15 to the Consolidated Financial Statements in our 2009 Annual Report on Form 10-K.

As of June 30, 2010, our total liabilities for unrecognized tax benefits were approximately \$142 million, which were excluded from the table above. We believe it is reasonably possible that our liabilities for unrecognized tax benefits may decrease by \$27 million within the next twelve months, primarily as a result of the expiration of statutes of limitations, settlements and/or the conclusion of tax examinations on certain tax positions. For the remainder, we cannot make reasonably reliable estimates of the timing of the future payments of these liabilities. See Note 5 to the Consolidated Financial Statements in our 2009 Annual Report on Form 10-K for information regarding our contingent tax liability reserves.

Our credit agreements and our term loan due May 2012 contain various covenants and conditions, including the maintenance of certain financial ratios, that could impact our ability to, among other things, incur additional indebtedness. As of June 30, 2010, we were in compliance with the various financial covenants included in our credit agreements and we do not expect these covenants to adversely impact our ability to execute our growth strategy or conduct normal business operations.

Unconsolidated Joint Ventures

We have investments in unconsolidated joint ventures in Phoenix, Arizona; Indianapolis, Indiana; and Dayton, Ohio, which are accounted for under the equity method of accounting. We believe that our transactions with our joint ventures are conducted in all material respects at arms length, reflecting current market conditions and pricing. Total net revenues of our unconsolidated joint ventures equal less than 6% of our consolidated net revenues. Total assets associated with our unconsolidated joint ventures are less than 2% of our consolidated total assets. We have no material unconditional obligations or guarantees to, or in support of, our unconsolidated joint ventures and their operations.

Requirements and Capital Resources

We estimate that we will invest approximately \$200 million during 2010 for capital expenditures to support and expand our existing operations, principally related to investments in information technology, equipment, and facility upgrades.

As of June 30, 2010, \$1.3 billion of borrowing capacity was available under our existing credit facilities, consisting of \$525 million available under our secured receivables credit facility and \$750 million available under our senior unsecured revolving credit facility.

We believe the banks participating in our various credit facilities are predominantly highly-rated banks, and that the amounts under the credit facilities are currently available to us. Should one or several banks no longer participate in either of our credit facilities, we would not expect it to impact our ability to fund operations.

We believe that cash and cash equivalents on-hand and cash from operations, together with our borrowing capacity under our credit facilities, will provide sufficient financial flexibility to meet seasonal working capital requirements and to fund capital expenditures, debt service requirements, cash dividends on common shares, share repurchases and additional growth opportunities for the foreseeable future. We believe that our credit profile should provide us with access to additional financing, if necessary, to fund growth opportunities that cannot be funded from existing sources.

New Accounting Standards

In October 2009, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting standards related to the accounting for revenue in arrangements with multiple deliverables, and an amendment to the accounting standards related to certain revenue arrangements that include software elements. In January 2010, the FASB issued an amendment to the accounting standards related to the disclosures about an entity's use of fair value measurements. In February 2010, the FASB issued an amendment to the accounting standards related to the accounting for, and disclosure of, subsequent events in an entity's consolidated financial statements. The impact of these accounting standards is discussed in Note 2 to the interim consolidated financial statements.

Forward-Looking Statements

Some statements and disclosures in this document are forward-looking statements. Forward-looking statements include all statements that do not relate solely to historical or current facts and can be identified by the use of words such as may, believe, will, expect, project, estimate, anticipate, plan or continue. These forward-looking statements are based on our current plans and expectations and are subject to a number of risks and uncertainties that could significantly cause our plans and expectations, including actual results, to differ materially from the forward-looking statements. Risks and uncertainties that may affect our future results include, but are not limited to, adverse results from pending or future government investigations, lawsuits or private actions, the competitive environment, changes in government regulations, changing relationships with customers, payers, suppliers and strategic partners and other factors discussed in Business, Risk Factors, Cautionary Factors That May Affect Future Results, Legal Proceedings, Management's Discussion and Analysis of Financial Condition and Results of Operations, and Quantitative and Qualitative Disclosures About Market Risk in our 2009 Annual Report on Form 10-K and Management's Discussion and Analysis of Financial Condition and Results of Operations, Quantitative and Qualitative Disclosures About Market Risk and Risk Factors in our 2010 Quarterly Reports on Form 10-Q and other items throughout the 2009 Form 10-K and our 2010 Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

During the second quarter of 2010, there were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended) that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

See Note 9 to the interim consolidated financial statements for information regarding the status of legal proceedings involving the Company.

Item 1A. Risk Factors

In addition to the risk factors set forth in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2009, investors should consider the following risk factor before deciding to invest in any securities issued by the Company.

U.S. healthcare reform legislation may result in significant change, and our business could be adversely impacted if we fail to adapt.

Government oversight of and attention to the healthcare industry in the United States is significant and increasing. In March 2010, U.S. federal legislation was enacted to reform healthcare. The legislation provides for reductions in the Medicare clinical laboratory fee schedule of 1.75% for five years beginning in 2011 and also includes a productivity adjustment which reduces the CPI market basket update beginning in 2011. In 2009, approximately 12% of our consolidated revenues were reimbursed by Medicare under the clinical laboratory fee schedule. The legislation imposes an excise tax on the seller for the sale of certain medical devices in the United States, including those purchased and used by laboratories, beginning in 2013. The legislation establishes the Independent Payment Advisory Board, which will be responsible, beginning in 2014, annually to submit proposals aimed at reducing Medicare cost growth while preserving quality. These proposals automatically will be implemented unless Congress enacts alternative proposals that achieve the same savings targets. Further, the legislation calls for a Center for Medicare and Medicaid Innovation that will examine alternative payment methodologies and conduct demonstration programs. The legislation provides for extensive health insurance reforms, including the elimination of pre-existing condition exclusions and other limitations on coverage, fixed percentages on medical loss ratios, expansion in Medicaid and other programs, employer mandates, individual mandates, creation of state and regional health insurance exchanges, and tax subsidies for individuals to help cover the cost of individual insurance coverage. The legislation also permits the establishment of accountable care organizations, a new healthcare delivery model. While the ultimate impact of the legislation on the healthcare industry is unknown, it is likely to be extensive and may result in significant change. Our failure to adapt to these changes could have a material adverse effect on our business.

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

The table below sets forth the information with respect to purchases made by or on behalf of the Company of its common stock during the second quarter of 2010.

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (in thousands) |
|--------------------------------|---|-------------------------------------|---|--|
| April 1, 2010 – April 30, 2010 | | | | |
| Share Repurchase Program (A) | 174,654 | \$ 57.91 | 174,654 | \$ 489,224 |
| Employee Transactions (B) | 66 | \$ 58.07 | N/A | N/A |
| May 1, 2010 – May 31, 2010 | | | | |
| Share Repurchase Program (A) | 1,330,903 | \$ 53.94 | 1,330,903 | \$ 417,435 |
| Employee Transactions (B) | 3,155 | \$ 55.32 | N/A | N/A |
| June 1, 2010 – June 30, 2010 | | | | |
| Share Repurchase Program (A) | 1,775,300 | \$ 52.47 | 1,775,300 | \$ 324,277 |
| Employee Transactions (B) | 548 | \$ 52.43 | N/A | N/A |
| Total | | | | |
| Share Repurchase Program (A) | 3,280,857 | \$ 53.36 | 3,280,857 | \$ 324,277 |
| Employee Transactions (B) | 3,769 | \$ 54.95 | N/A | N/A |

- (A) In January 2010, our Board of Directors authorized the Company to repurchase an additional \$750 million of the Company's common stock. Since the share repurchase program's inception in May 2003, our Board of Directors has authorized \$3.5 billion of share repurchases of our common stock through June 30, 2010. The share repurchase authorization has no set expiration or termination date.
- (B) Includes: (1) shares delivered or attested to in satisfaction of the exercise price and/or tax withholding obligations by holders of stock options (granted under the Company's Amended and Restated Employee Long-Term Incentive Plan and its Amended and Restated Non-Employee Director Long-Term Incentive Plan, collectively the "Stock Compensation Plans") who exercised options; (2) restricted common shares withheld (under the terms of grants under the Stock Compensation Plans) to offset tax withholding obligations that occur upon vesting and release of the restricted common shares; and (3) shares withheld (under the terms of grants under the Stock Compensation Plans) to offset tax withholding obligations that occur upon the delivery of common shares underlying restricted stock units and performance share units.

Item 6. Exhibits

Exhibits:

- 10.1 Amendment dated May 6, 2010 to the Stockholders Agreement dated as of August 16, 1999 between Quest Diagnostics Incorporated and SmithKline Beecham plc
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. §1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. §1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS dgx-20100630.xml
- 101.SCH dgx-20100630.xsd
- 101.CAL dgx-20100630_cal.xml
- 101.DEF dgx-20100630_def.xml
- 101.LAB dgx-20100630_lab.xml
- 101.PRE dgx-20100630_pre.xml
- 101.REF dgx-20100630_ref.xml

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.

July 27, 2010

Quest Diagnostics Incorporated

By /s/ Surya N. Mohapatra

Surya N. Mohapatra, Ph.D.
Chairman of the Board, President and Chief Executive Officer

By /s/ Robert A. Hagemann

Robert A. Hagemann
Senior Vice President and
Chief Financial Officer