HEALTHSOUTH CORP
Form 10-Q
November 05, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

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

Commission File Number 001-10315

HealthSouth Corporation

(Exact name of Registrant as specified in its Charter)

Delaware	**63-0860407**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
3660 Grandview Parkway, Suite 200 Birmingham, Alabama	**35243**
(Address of Principal Executive Offices)	**(Zip Code)**

(205) 967-7116

(Registrant's telephone 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 x No o

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

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

The registrant had 88,022,103 shares of common stock outstanding, net of treasury shares, as of October 31, 2008.

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Condensed Consolidated Balance Sheets

(Unaudited)

	September 30, 2008	December 31, 2007
	(In Millions, Except Share Data)	
Assets		
Current Assets:		
Cash and cash equivalents	$ 24.9	$ 19.8
Restricted cash	73.4	63.6
Restricted marketable securities	27.8	28.9
Accounts receivable, net of allowance for doubtful accounts of $33.9 in 2008; $37.6 in 2007	226.0	217.7
Insurance recoveries receivable	230.0	230.0
Other current assets	54.9	58.4
Current assets held for sale	5.2	19.0
Total current assets	642.2	637.4
Property and equipment, net	676.9	729.6
Goodwill	414.4	406.1
Intangible assets, net	44.5	26.1
Investments in and advances to nonconsolidated affiliates	42.6	42.7
Assets held for sale	27.3	78.0
Income tax refund receivable	62.9	52.5
Other long-term assets	69.7	78.2
Total assets	$ 1,980.5	$ 2,050.6
Liabilities and Shareholders' Deficit		
Current Liabilities:		
Current portion of long-term debt	$ 56.0	$ 68.3
Accounts payable	40.6	48.7
Accrued expenses and other current liabilities	360.7	364.2
Government, class action, and related settlements	367.7	400.7
Current liabilities held for sale	35.1	88.6
Total current liabilities	860.1	970.5
Long-term debt, net of current portion	1,820.8	1,974.4
Liabilities held for sale	3.7	4.2
Other long-term liabilities	170.0	171.4
	2,854.6	3,120.5
Commitments and contingencies		
Minority interest in equity of consolidated affiliates	84.7	97.2
Convertible perpetual preferred stock, $.10 par value; 1,500,000 shares authorized; 400,000 issued in 2008 and 2007; liquidation preference of $1,000 per share	387.4	387.4
Shareholders' deficit:		
Common stock, $.01 par value; 200,000,000 shares authorized; issued: 96,890,424 in 2008; 87,514,378 in 2007	1.0	0.9

Capital in excess of par value	2,959.7	2,820.4
Accumulated deficit	(3,994.1)	(4,064.6)
Accumulated other comprehensive loss	(1.4)	(0.8)
Treasury stock, at cost (8,861,571 in 2008 and 8,801,665 shares in 2007)	(311.4)	(310.4)
Total shareholders' deficit	(1,346.2)	(1,554.5)
Total liabilities and shareholders' deficit	$ 1,980.5	$ 2,050.6

The accompanying notes to condensed consolidated financial

statements are an integral part of these condensed balance sheets.

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HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Operations and Comprehensive Income

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In Millions)			
Net operating revenues	$ 456.2	$ 428.3	$ 1,378.6	$ 1,302.9
Operating expenses:				
Salaries and benefits	236.5	214.4	701.0	646.2
Other operating expenses	68.9	63.7	202.1	187.6
General and administrative expenses	25.5	25.8	78.8	101.8
Supplies	26.2	24.1	81.1	74.9
Depreciation and amortization	18.1	19.5	65.8	56.9
Impairment of long-lived assets	–	0.4	0.6	15.1
Occupancy costs	12.8	12.9	37.6	38.5
Provision for doubtful accounts	6.7	5.6	20.8	26.2
Loss on disposal of assets	0.2	0.6	0.6	2.2
Government, class action, and related settlements	17.1	3.9	(27.9)	(34.0)
Professional fees—accounting, tax, and legal	4.0	9.2	12.9	44.3
Total operating expenses	416.0	380.1	1,173.4	1,159.7
Loss on early extinguishment of debt	2.1	2.2	5.8	19.9
Interest expense and amortization of debt discounts and fees	40.4	60.2	131.3	177.9
Other income	(0.4)	(9.4)	(2.1)	(14.5)
Loss on interest rate swap	8.0	21.4	16.1	6.8
Equity in net income of nonconsolidated affiliates	(2.7)	(2.3)	(7.8)	(7.4)
Minority interests in earnings of consolidated affiliates	5.9	7.2	21.7	23.2
(Loss) income from continuing operations before income tax benefit	(13.1)	(31.1)	40.2	(62.7)
Provision for income tax benefit	(22.5)	(281.2)	(21.7)	(288.2)
Income from continuing operations	9.4	250.1	61.9	225.5
(Loss) income from discontinued operations, net of income tax (expense) benefit	(2.8)	37.5	8.6	473.7
Net income	6.6	287.6	70.5	699.2
Convertible perpetual preferred stock dividends	(6.5)	(6.5)	(19.5)	(19.5)
Net income available to common shareholders	$ 0.1	$ 281.1	$ 51.0	$ 679.7
Comprehensive income:				
Net income	$ 6.6	$ 287.6	$ 70.5	$ 699.2
Other comprehensive income, net of tax:				
Foreign currency translation adjustment	–	–	0.8	0.1
Unrealized (loss) gain on available-for-sale securities	(0.6)	0.3	(1.4)	(3.0)

Other comprehensive (loss) income, net of tax	(0.6)		0.3		(0.6)		(2.9)	
Comprehensive income	$	6.0	$	287.9	$	69.9	$	696.3

(Continued)

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HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Operations and Comprehensive Income (Continued)

(Unaudited)

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008		2007		2008		2007	
	(In Millions, Except Per Share Data)							
Weighted average common shares outstanding:								
Basic	87.4		78.5		81.6		78.6	
Diluted	101.0		91.8		95.1		91.9	
Earnings per common share:								
Basic:								
Income from continuing operations available to common shareholders	$	0.03	$	3.10	$	0.52	$	2.62
(Loss) income from discontinued operations, net of income tax expense	(0.03)		0.48		0.11		6.03	
Net income per share available to common shareholders	$	0.00	$	3.58	$	0.63	$	8.65
Diluted:								
Income from continuing operations available to common shareholders	$	0.03	$	2.72	$	0.52	$	2.45
(Loss) income from discontinued operations, net of income tax expense	(0.03)		0.41		0.11		5.16	
Net income per share available to common shareholders	$	0.00	$	3.13	$	0.63	$	7.61

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

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HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended September 30, 2008	2007
	(In Millions)	
Net cash provided by (used in) operating activities	$ 149.3	$ (139.1)
Cash flows from investing activities:		
Capital expenditures	(39.5)	(25.1)
Acquisition of business, net of cash acquired	(14.6)	–
Acquisition of intangible assets	(18.2)	–
Proceeds from disposal of assets	53.8	0.4
Proceeds from sale and maturities of restricted marketable securities	2.4	65.8
Purchase of restricted investments	(3.3)	(11.3)
Net change in restricted cash, excluding cash in escrow related to debt	20.5	7.1
Net settlements on interest rate swap	(13.9)	1.8
Other	0.6	–
Net cash provided by investing activities of discontinued operations -		
Proceeds from divestitures of divisions	–	1,146.3
Other investing activities of discontinued operations	0.3	2.9
Net cash (used in) provided by investing activities	(11.9)	1,187.9
Cash flows from financing activities:		
Checks in excess of bank balance	(11.4)	10.6
Change in restricted cash for amounts in escrow related to debt	(30.3)	–
Principal payments on debt, including pre-payments	(121.5)	(920.9)
Borrowings on revolving credit facility	88.0	260.0
Payments on revolving credit facility	(150.0)	(315.0)
Principal payments under capital lease obligations	(10.8)	(9.6)
Issuance of common stock	150.2	–
Dividends paid on convertible perpetual preferred stock	(19.5)	(19.5)
Debt amendment costs	–	(11.2)
Distributions to minority interests of consolidated affiliates	(26.3)	(19.5)
Other	(0.3)	0.1
Net cash used in financing activities of discontinued operations	(1.5)	(48.3)
Net cash used in financing activities	(133.4)	(1,073.3)
Effect of exchange rate changes on cash and cash equivalents	0.8	0.1
Increase (decrease) in cash and cash equivalents	4.8	(24.4)
Cash and cash equivalents at beginning of period	19.8	27.1
Cash and cash equivalents of divisions and facilities held for sale at beginning of period	0.4	14.4

Less: Cash and cash equivalents of divisions and facilities held for sale at end of period	(0.1)		(1.2)	
Cash and cash equivalents at end of period	$	24.9	$	15.9

The accompanying notes to condensed consolidated financial

statements are an integral part of these condensed statements.

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HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation:

HealthSouth Corporation, incorporated in Delaware in 1984, including its subsidiaries, is the largest provider of inpatient rehabilitation services in the United States. We operate inpatient rehabilitation hospitals and long-term acute care hospitals and provide treatment on both an inpatient and outpatient basis. References herein to “HealthSouth,” the “Company,” “we,” “our,” or “us” refer to HealthSouth Corporation and its subsidiaries unless otherwise stated or indicated by context.

The accompanying unaudited condensed consolidated financial statements of HealthSouth Corporation and Subsidiaries should be read in conjunction with the consolidated financial statements and accompanying notes filed with the United States Securities and Exchange Commission (the “SEC”) in HealthSouth’s Annual Report on Form 10-K filed on February 26, 2008 (the “2007 Form 10-K”). The unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the SEC applicable to interim financial information. Certain information and note disclosures included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”) have been omitted in these interim statements, as allowed by such SEC rules and regulations. The condensed consolidated balance sheet as of December 31, 2007 has been derived from audited financial statements, but it does not include all disclosures required by GAAP. However, we believe the disclosures are adequate to make the information presented not misleading.

The unaudited results of operations for the interim periods shown in these financial statements are not necessarily indicative of operating results for the entire year. In our opinion, the accompanying condensed consolidated financial statements recognize all adjustments of a normal recurring nature considered necessary to fairly state the financial position, results of operations, and cash flows for each interim period presented.

Reclassifications—

Certain financial results have been reclassified to conform to the current period presentation. Such reclassifications primarily relate to one hospital and one gamma knife radiosurgery center we identified in the three months ended September 30, 2008 that qualify under Financial Accounting Standards Board (“FASB”) Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to be reported as assets held for sale and discontinued operations. We reclassified our condensed consolidated balance sheet as of December 31, 2007 to show the assets and liabilities of these qualifying facilities as held for sale. We also reclassified our condensed consolidated statements of operations and comprehensive income for the three and nine months ended September 30, 2007 and our condensed consolidated statement of cash flows for the nine months ended September 30, 2007 to show the results of these qualifying facilities as discontinued operations.

Business Combinations—

On July 31, 2008, we completed the acquisition of The Rehabilitation Hospital of South Jersey. We accounted for this acquisition under the purchase method of accounting in accordance with FASB Statement No. 141, *Business Combinations*, and reported the results of operations of the acquired hospital from the date of acquisition. We have not prepared pro forma financial information as the results of operations of this acquired company and its assets are not material on a consolidated basis.

In August 2008, we acquired an inpatient rehabilitation unit at the Medical Center of Arlington in Texas. In August 2008, we also acquired an inpatient rehabilitation hospital in Midland, Texas from Rehabcare Corporation. The operations of both of these facilities were relocated to existing HealthSouth hospitals in the respective areas. Under the guidance of FASB Statement No. 141 and Emerging Issues Task Force (“EITF”) Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,” neither of these transactions qualified as the purchase of a “business.” Therefore, we accounted for the purchase of these discrete sets of assets under the guidance in FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

See Note 4, *Goodwill and Other Intangible Assets*, for additional information related to the above transactions.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Stock-Based Compensation—

In February 2008, we issued approximately 0.7 million shares of restricted common stock to members of our senior management team. Approximately 0.4 million shares of the restricted stock granted contain only a service condition, while the remaining 0.3 million shares contain a service and either a performance or market condition. The fair value of the awards containing a market condition is calculated using a lattice model. However, these amounts are not material to our financial position, results of operations, or cash flows.

Fair Value Measurements—

On January 1, 2008, we adopted FASB Statement No. 157, *Fair Value Measurements*, which establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. FASB Statement No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering assumptions, FASB Statement No. 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

- *Level 1* – Observable inputs such as quoted prices in active markets;
- *Level 2* – Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
- *Level 3* – Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of three valuation techniques noted in FASB Statement No. 157. The three valuation techniques are as follows:

- *Market approach* – Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities;
- *Cost approach* – Amount that would be required to replace the service capacity of an asset (i.e., replacement cost); and
- *Income approach* – Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing models, and lattice models).

On a recurring basis, we are required to measure our available-for-sale restricted and nonrestricted marketable securities, the liability for the common stock and related common stock warrants associated with the securities litigation settlement (see Note 12, *Securities Litigation Settlement*), and our interest rate swap at fair value. The fair values of our available-for-sale restricted and nonrestricted marketable securities and the liability for the common stock associated with the securities litigation settlement are determined based on quoted market prices in active markets. The fair value of the liability for the common stock warrants associated with the securities litigation settlement is determined using a Black-Scholes model with weighted-average assumptions for historical volatility of our common stock, the risk-free interest rate, and the expected term of the underlying warrants. The fair value of our interest rate swap is determined using the present value of the fixed leg and floating leg of the swap. The value of the fixed leg is the present value of the known fixed coupon payments discounted at the rates implied by the LIBOR-swap curve. The value of the floating leg is the present value of the floating coupon payments which are derived from the forward LIBOR-swap rates and discounted at rates from the same yield curve. Each series of cash flows is discounted by market rates of interest.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

The fair values of our financial assets and liabilities that are measured on a recurring basis are as follows (in millions):

		Fair Value Measurements at Reporting Date Using			
September 30, 2008	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Valuation Technique** [1]
Restricted marketable securities	$ 27.8	$ 27.8	$ –	$ –	M
Other current assets:					
Marketable securities	0.6	0.6	–	–	M
Accrued expenses and other current liabilities:					
Interest rate swap	(45.5)	–	(45.5)	–	I
Government, class action, and related settlements:					
Securities Litigation Settlement liability—common stock	(92.6)	(92.6)	–	–	M
Securities Litigation Settlement liability—common stock warrants	(38.6)	–	(38.6)	–	I

(1) As discussed above, FASB Statement No. 157 identifies three valuation techniques: market approach (M), cost approach (C), and income approach (I).

On a nonrecurring basis, we are required to measure property and equipment, goodwill, other intangible assets, investments in nonconsolidated affiliates, and assets and liabilities of discontinued operations at fair value. The fair value of our property and equipment is determined using discounted cash flows and significant unobservable inputs, unless there is an offer to purchase such assets, which would be the basis for determining fair value. The fair value of our intangible assets, excluding goodwill, is determined using discounted cash flows and significant unobservable inputs. The fair value of our investments in nonconsolidated affiliates is determined using quoted prices in private markets, discounted cash flows or earnings, or market multiples derived from a set of comparables. The fair value of our assets and liabilities of discontinued operations is determined using discounted cash flows and significant unobservable inputs unless there is an offer to purchase such assets and liabilities, which would be the basis for determining fair value. The fair value of our goodwill is determined using discounted cash flows, and, when available and as appropriate, we use comparative market multiples to corroborate discounted cash flow results. Goodwill is tested for impairment as of October 1st of each year, absent any impairment indicators.

FASB Staff Position ("FSP") No. 157-2, *Effective Date of FASB Statement No. 157*, delayed the effective date of FASB Statement No. 157 by one year for nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. During the nine months ended September 30, 2008, we recorded an impairment charge of $0.6 million. This charge represented our write-down of certain long-lived assets associated with one of our hospitals to their estimated fair value based on an offer we received from a third party to acquire the assets. During the three and nine months ended September 30, 2007, we recorded impairment charges of $0.4 million and $15.1 million, respectively, related to our long-lived assets. Approximately $14.5 million of these charges during the nine months ended September 30, 2007 related to the Digital Hospital (as defined in Note 5, *Property and Equipment*, to the consolidated financial statements included in our 2007 Form 10-K). During 2007, we wrote the Digital Hospital down by $14.5 million to its estimated fair value based on an offer we had received from a third party to acquire our corporate campus and the estimated net proceeds we expected to receive from this potential sale transaction.

During the three and nine months ended September 30, 2008, we recorded impairment charges of $8.4 million and $9.0 million, respectively, as part of our results of discontinued operations. During the three and nine months ended September 30, 2007, we recorded impairment charges of $1.3 million and $37.2 million, respectively, as part of our results of discontinued operations. See Note 9, *Assets Held for Sale and Results of Discontinued Operations*.

In October 2008, the FASB issued FSP No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. FSP No. FAS 157-3 clarified the application of FASB Statement No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. It also

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

reaffirmed the notion of fair value as an exit price as of the measurement date. The guidance also clarified how management's internal cash flow and discount rate assumptions should be considered when measuring fair value when relevant observable data does not exist, how observable market information in a market that is not active should be considered when measuring fair value, and how the use of market quotes (e.g., broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value. The FSP was effective upon issuance, including prior periods for which financial statements had not been issued, or the third quarter of 2008 for HealthSouth. The issuance of this FSP did not have a material impact on our financial position, results of operation, or cash flows, nor did it significantly impact the way in which we estimate the fair value of our financial assets.

Recent Accounting Pronouncements—

In December 2007, the FASB issued FASB Statement No. 141 (Revised 2007), *Business Combinations*. FASB Statement No. 141(R) contains significant changes in the accounting for and reporting of business acquisitions, and it continues the movement toward the greater use of fair values in financial reporting and increased transparency through expanded disclosures. It changes how business acquisitions are accounted for and will impact financial statements at the acquisition date and in subsequent periods. Further, certain of the changes will introduce more volatility into earnings and thus may impact a company's acquisition strategy. In addition, FASB Statement No. 141(R) will impact the annual goodwill impairment test associated with acquisitions that close both before and after the effective date of the new standard. FASB Statement No. 141(R) will be applied prospectively to business combinations for which the acquisition date is on or after the beginning of an entity's first annual reporting period beginning on or after December 15, 2008, or January 1, 2009 for HealthSouth. We do not expect the adoption of FASB Statement No. 141(R) to have a material impact on our financial position, results of operations, or cash flows.

In December 2007, the FASB issued FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. FASB Statement No. 160 establishes accounting and reporting standards for minority interests (recharacterized as noncontrolling interests and classified as a component of equity) and for the deconsolidation of a subsidiary. FASB Statement No. 160 is effective for fiscal years beginning on or after December 15, 2008, or January 1, 2009 for HealthSouth. The Statement is to be applied prospectively, however the presentation and disclosure requirements of the Statement will need to be applied retrospectively for all periods presented. We do not expect the adoption of FASB Statement No. 160 to have a material impact on our financial position, results of operations, or cash flows. However, it will change the way in which we account for and report our minority interests.

In March 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*. FASB Statement No. 161 is intended to help investors better understand how derivative instruments and hedging activities affect an entity's financial position, operations, and cash flows through enhanced disclosure requirements. The Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, or January 1, 2009 for HealthSouth.

We do not expect FASB Statement No. 161 to significantly change the way in which we currently disclose our derivative instrument. As of September 30, 2008, we maintained only one derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This instrument is an interest rate swap we are required to maintain under the terms of our Credit Agreement (as defined in Note 8, *Long-term Debt*, to the consolidated financial statements accompanying our 2007 Form 10-K). For additional information regarding our derivative instrument, see Note 1, *Summary of Significant Accounting Policies*, "Derivative Instruments," and Note 8, *Long-term Debt*, "Interest Rate Swap," of the notes to the consolidated financial statements included in our 2007 Form 10-K.

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under FASB Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141(R) and other GAAP. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, or January 1, 2009 for

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

HealthSouth. The guidance within the FSP for determining the useful life of a recognized intangible asset will be applied prospectively to intangible assets acquired after the effective date. The additional disclosure requirements of the FSP will be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. We do not expect the adoption of this FSP to have a material impact on our financial position, results of operations, or cash flows.

Since the filing of our 2007 Form 10-K, we do not believe any other recently issued, but not yet effective, accounting standards will have a material effect on our consolidated financial position, results of operations, or cash flows.

2. Liquidity:

While we continue to make progress in improving our leverage and liquidity, we remain highly leveraged.

With the continued deleveraging of the Company as a priority, on June 27, 2008, we finalized the issuance and sale of 8.8 million shares of our common stock to J.P. Morgan Securities Inc. for net proceeds of approximately $150 million (see Note 7, *Shareholders' Deficit*) and used the majority of these net proceeds to reduce our total debt outstanding. This debt reduction was in addition to the use of the net proceeds from the sale of our corporate campus (see Note 3, *Property and Equipment*) in April 2008 to reduce total debt outstanding. In addition, during October 2008, we used the majority of our federal income tax refund for tax years 2000 through 2003 (see Note 10, *Income Taxes*) to reduce amounts outstanding under our Credit Agreement. In total and through October 2008, we have reduced our total debt outstanding by approximately $208 million since December 31, 2007.

In addition, we plan to use the majority of the net proceeds from our settlement with UBS Securities, LLC and UBS AG, Stamford Branch (see Note 13, *Contingencies*) to reduce long-term debt. However, no assurances can be given as to the exact timing of the receipt of such proceeds.

Our primary sources of funding are cash flows from operations and borrowings under our revolving credit facility. As of September 30, 2008, we had approximately $24.9 million in *Cash and cash equivalents*. This amount excludes approximately $73.4 million in *Restricted cash* and $27.8 million of *Restricted marketable securities*, which are assets whose use is restricted because of various obligations we have under lending agreements, partnership agreements, and other arrangements, primarily related to our captive insurance company. As of September 30, 2008, *Restricted cash* included approximately $30.3 million held in escrow by the trustee of our 10.750% Senior Subordinated Notes due 2008. This cash was used to redeem the remaining balance of these notes on their maturity date of October 1, 2008 (see Note 6, *Long-term Debt*) and is included in the total debt reduction discussed in the previous paragraph.

In light of the current global economic situation, we have evaluated and quantified, to the extent practicable, our exposure to counterparties who have or may likely experience significant threats to their ability to adequately service our needs. We monitor the financial strength of our depositories, creditors, derivative counterparties, and insurance carriers using publicly available information, as well as qualitative inputs. We have recently drawn on the revolving credit facility and issued letters of credit under its subfacility without incident. More specifically, on September 30, 2008, we drew $13.0 million on our revolving credit facility, and on October 15, 2008, we made an additional $40.0 million draw, both of which were used for general corporate purposes. Based on our current borrowing capacity and compliance with the financial covenants under our Credit Agreement, we do not believe there is significant risk in our ability to make additional draws under our revolving credit facility, if needed. However, no such assurances can be provided.

In addition, we do not face substantial refinancing risk, as our revolving credit facility does not expire until 2012, our Term Loan Facility does not mature until 2013, and the majority of our bonds are not due until 2014 and 2016.

We have additional scheduled principal payments, including debt maturities, of $6.1 million (in addition to the $30.3 million redemption of the 10.750% Senior Subordinated Notes that was made on October 1, 2008, as discussed above) and $25.3 million in the remainder of 2008 and 2009, respectively, related to long-term debt obligations (see Note 6, *Long-term Debt*).

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As with any company carrying significant debt, our primary risk relating to our high leverage is the possibility that a rapid increase in interest rates and/or a down-turn in operating earnings could impair our ability to comply with the financial covenants contained within our Credit Agreement. Loans under our Credit Agreement bear interest at a rate of, at our option, 1-month, 2-month, 3-month, or 6-month LIBOR or the Prime rate, plus an applicable margin that varies depending upon our leverage ratio and corporate credit rating. Our primary covenants include a leverage ratio and an interest coverage ratio. To violate the interest coverage ratio, we would need to fail the test for four consecutive quarters. As of September 30, 2008, we were in compliance with the covenants under our Credit Agreement. If we anticipated a potential covenant violation, we would seek relief from our lenders, which would have some cost to us, and such relief might not be on terms as favorable to those in our existing Credit Agreement. Under such circumstances, there is also the potential our lenders would not grant relief to us which, among other things, would depend upon the state of the credit markets at that time. A default due to violation of the covenants contained within our Credit Agreement, if not cured, could require us to immediately repay all amounts then outstanding under the Credit Agreement. See Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying our 2007 Form 10-K, for a discussion of risks and uncertainties facing us. Changes in our business or other factors may occur that might have a material adverse impact on our financial position, results of operations, and cash flows.

3. Property and Equipment:

Property and equipment consists of the following (in millions):

	September 30, 2008	December 31, 2007
Land	$ 66.1	$ 74.9
Buildings	889.7	917.0
Leasehold improvements	26.4	24.1
Furniture, fixtures, and equipment	342.4	340.5
	1,324.6	1,356.5
Less: Accumulated depreciation and amortization	(655.1)	(634.5)
	669.5	722.0
Construction in progress	7.4	7.6
Property and equipment, net	$ 676.9	$ 729.6

Corporate Campus—

In January 2008, we entered into an agreement with Daniel Corporation (“Daniel”), a Birmingham, Alabama-based full-service real estate organization, pursuant to which Daniel acquired our corporate campus, including the Digital Hospital, for a purchase price of $43.5 million in cash. This transaction closed on March 31, 2008. As part of this transaction, we entered into a lease for office space within the property that was sold.

In accordance with FASB Statement No. 144, we reviewed our depreciation estimates of our corporate campus based on the revised salvage value of the campus due to the expected sale transaction. During the first quarter of 2008, we accelerated the depreciation of our corporate campus by approximately $11.0 million so that the net book value of the corporate campus equaled the net proceeds received on the transaction’s closing date.

The proceeds of this transaction were used to reduce our debt outstanding in April 2008 (see Note 6, *Long-term Debt*).

The agreement includes a deferred purchase price component related to the Digital Hospital. If Daniel sells, or otherwise monetizes its interest in, the Digital Hospital for cash consideration to a third party, we are entitled to 40% of the net profit, if any and as defined in the sale agreement, realized by Daniel. In September 2008, Daniel Corporation announced that it had reached an agreement with Trinity Medical Center (“Trinity”) pursuant to which Trinity will acquire the Digital Hospital. The purchase price of this transaction has not been made public, and the transaction is subject to Trinity receiving approval for a certificate of need (“CON”) from the applicable state board of Alabama. Currently, there is opposition to the potential approval of Trinity’s CON request, and it could take months to finalize any decision by the applicable Alabama board. Therefore, no

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assurances can be given as to whether or when any such cash flows related to the deferred purchase price component of our agreement with Daniel will be received, if any, if Daniel is able to realize a net profit on its transaction with Trinity.

4. Goodwill and Other Intangible Assets:

As discussed in Note 1, *Basis of Presentation*, we completed the acquisition of The Rehabilitation Hospital of South Jersey on July 31, 2008. As a result of this transaction, our *Goodwill* increased from $406.1 million as of December 31, 2007 to $414.4 million as of September 30, 2008.

As discussed in Note 1, *Basis of Presentation*, we also completed two market consolidation transactions during the third quarter of 2008. As a result of all three transactions, our other intangible assets have increased. The following table provides information regarding our other intangible assets (in millions):

	Gross Carrying Amount		Accumulated Amortization		Net	
Certificates of need:						
September 30, 2008	$	5.8	$	(1.7)	$	4.1
December 31, 2007	2.7		(1.6)		1.1	
Licenses:						
September 30, 2008	$	50.7	$	(34.3)	$	16.4
December 31, 2007	50.3		(32.5)		17.8	
Noncompete agreements:						
September 30, 2008	$	17.0	$	(6.1)	$	10.9
December 31, 2007	11.8		(4.6)		7.2	
Market access assets:						
September 30, 2008	$	13.2	$	(0.1)	$	13.1
December 31, 2007	–		–		–	
Total intangible assets:						
September 30, 2008	$	86.7	$	(42.2)	$	44.5
December 31, 2007	64.8		(38.7)		26.1	

None of our other intangible assets has an estimated residual value. The range of estimated useful lives and the amortization basis for our other intangible assets are as follows:

	Estimated Useful Life and Amortization Basis
Certificates of need	13 to 30 years using straight-line basis
Licenses	10 to 20 years using straight-line basis
Noncompete agreements	3 to 10 years using straight-line basis
Market access assets	20 years using accelerated basis

The market access assets acquired during 2008 were valued using discounted cash flows under the income approach. The value of the market access assets is attributable to our ability to gain access to and penetrate the former facilities' historical market patient base. To determine this value, we first developed a debt-free net cash flow forecast under various patient volume scenarios. The debt-free net cash flow was then discounted back to present value using a discount factor, which included an adjustment for company-specific risk. As noted in the above table, we are amortizing these assets over 20 years using an accelerated basis that reflects the pattern in which we believe the economic benefits of the market access assets will be consumed.

Amortization expense for other intangible assets is as follows (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Amortization expense	$ 1.3	$ 1.1	$ 3.5	$ 3.2

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Total estimated amortization expense for our other intangible assets for the next five years is as follows (in millions):

	Estimated Amortization Expense
October 1 through December 31, 2008	$ 1.8
2009	7.1
2010	6.6
2011	6.2
2012	3.9
2013	3.7

5. Investments in and Advances to Nonconsolidated Affiliates:

Investments in and advances to nonconsolidated affiliates as of September 30, 2008 represents our investment in 18 partially owned subsidiaries, of which 13 are general or limited partnerships, limited liability companies, or joint ventures in which HealthSouth or one of our subsidiaries is a general or limited partner, managing member, member, or venturer, as applicable. We do not control these affiliates, but have the ability to exercise significant influence over the operating and financial policies of certain of these affiliates. Our ownership percentages in these affiliates range from 4% to 51%. We account for these investments using the cost and equity methods of accounting.

The following summarizes the combined results of operations of our equity method affiliates (on a 100% basis, in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net operating revenues	$ 17.8	$ 15.8	$ 55.1	$ 48.4
Operating expenses	(10.9)	(10.1)	(25.6)	(31.3)
Income from continuing operations	6.9	5.7	29.5	17.1
Net income	6.4	5.4	28.4	16.5

6. Long-term Debt:

Our long-term debt outstanding consists of the following (in millions):

	September 30, 2008	December 31, 2007
Advances under $400 million revolving credit facility	$ 13.0	$ 75.0
Term Loan Facility	818.7	862.8
Bonds Payable -		
7.000% Senior Notes due 2008	–	5.0
10.750% Senior Subordinated Notes due 2008	30.3	30.3
8.500% Senior Notes due 2008	–	9.4
8.375% Senior Notes due 2011	0.3	0.3
7.625% Senior Notes due 2012	1.5	1.5
Floating Rate Senior Notes due 2014	366.0	375.0
10.75% Senior Notes due 2016	512.7	558.2

Notes payable to banks and others at interest rates from 7.9% to 12.9%	12.9	17.0
Capital lease obligations	121.4	108.2
	1,876.8	2,042.7
Less: Current portion	(56.0)	(68.3)
Long-term debt, net of current portion	$ 1,820.8	$ 1,974.4

For a description of our indebtedness, see Note 8, *Long-term Debt*, to the consolidated financial statements accompanying our 2007 Form 10-K.

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The following chart shows scheduled principal payments due on long-term debt for the next five years and thereafter (in millions):

	Face Amount	Net Amount
October 1 through December 31, 2008	$ 36.4	$ 36.4
2009	25.3	25.3
2010	22.6	22.6
2011	21.7	21.7
2012	32.8	32.8
2013	792.7	792.7
Thereafter	952.0	945.3
Total	$ 1,883.5	$ 1,876.8

During the first quarter of 2008, we used drawings under our revolving credit facility to redeem approximately $5 million of our 10.75% Senior Notes due 2016, which carry a higher interest rate than borrowings under our Credit Agreement.

As discussed in Note 3, *Property and Equipment*, we closed the transaction to sell our corporate campus to Daniel on March 31, 2008. During April 2008, we used the net proceeds from this transaction to reduce amounts outstanding on our revolving credit facility.

As discussed in Note 7, *Shareholders' Deficit*, we finalized the issuance and sale of 8.8 million shares of our common stock on June 27, 2008. During the second and third quarters of 2008, we used the net proceeds from the equity offering to reduce amounts outstanding on our Term Loan Facility by $39.8 million, to redeem $41.6 million of our 10.75% Senior Notes due 2016, and to redeem $9.0 million of our Floating Rate Senior Notes due 2014. The remainder of the net proceeds was used to reduce amounts outstanding under our revolving credit facility.

As a result of the pre-payments and bond redemptions discussed above, we allocated a portion of the debt discounts and fees associated with this debt to the debt that was extinguished and expensed debt discounts and fees totaling approximately $0.8 million and $2.4 million to *Loss on early extinguishment of debt* during the three and nine months ended September 30, 2008, respectively. Our *Loss on early extinguishment of debt* for the three and nine months ended September 30, 2008 also includes $1.3 million and $3.4 million, respectively, of premiums associated with the redemption of the 10.75% Senior Notes due 2016 and Floating Rate Senior Notes due 2014.

As discussed in Note 2, *Liquidity*, *Restricted cash* as of September 30, 2008 includes $30.3 million held in escrow by the trustee of our 10.750% Senior Subordinated Notes due 2008. This cash was used to redeem the remaining balance of these notes on their maturity date of October 1, 2008.

In October 2008, we made a $40.0 million draw on our revolving credit facility for general corporate purposes. During October 2008, we also redeemed an additional $18.8 million of our 10.75% Senior Notes due 2016.

As discussed in Note 10, *Income Taxes*, in October 2008, we received a total cash refund of approximately $46 million (including interest) attributable to our settlement with the Internal Revenue Service (the "IRS") for tax years 2000 through 2003. We used $33.0 million of this refund to reduce amounts outstanding under our Credit Agreement. The remainder was used to pay expenses incurred to obtain the income tax refund and for other general corporate purposes.

In total and through October 2008, we have reduced our total debt outstanding by approximately $208 million since December 31, 2007. In addition, we plan to use the majority of the net proceeds from our settlement with UBS (see Note 13, *Contingencies*) to reduce long-term debt. However, no assurances can be given as to the exact timing of the receipt of such proceeds.

As a result of the above pre-payments during 2008, the quarterly installments due on our Term Loan Facility were reduced from approximately $2.2 million as of December 2007 to approximately $2.0 million as of October 2008, with the balance payable upon the final maturity of the Term Loan Facility in 2013.

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Due to the requirements under our Credit Agreement to use the net proceeds from the divestitures of our surgery centers, outpatient, and diagnostic divisions (as discussed in Note 1, *Summary of Significant Accounting Policies*, to our consolidated financial statements accompanying our 2007 Form 10-K) to repay obligations outstanding under our Credit Agreement, and in accordance with the guidance in EITF Issue No. 87-24, "Allocation of Interest to Discontinued Operations," we allocated the interest expense on the debt that was required to be repaid as a result of the disposal transactions to discontinued operations in all periods presented prior to the closing of the disposal transactions. The following table provides information regarding our total *Interest expense and amortization of debt discounts and fees* presented in our condensed consolidated statements of operations and comprehensive income for both continuing and discontinued operations (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Continuing operations:				
Interest expense	$ 38.8	$ 58.4	$ 126.4	$ 171.8
Amortization of debt discounts	0.1	0.2	0.4	0.4
Amortization of consent fees/bond issue costs	0.5	0.5	1.5	1.5
Amortization of loan fees	1.0	1.1	3.0	4.2
Total interest expense and amortization of debt discounts and fees for continuing operations	40.4	60.2	131.3	177.9
Discontinued operations:				
Interest expense	0.3	0.7	1.1	45.3
Total interest expense for discontinued operations	0.3	0.7	1.1	45.3
Total interest expense and amortization of debt discounts and fees	$ 40.7	$ 60.9	$ 132.4	$ 223.2

Our interest payments increase or decrease in accordance with changes in interest rates. However, the vast majority of our variable interest payments will be offset by net settlement payments or receipts on our interest rate swap, which are included in the line item *Loss on interest rate swap* in our condensed consolidated statements of operations and comprehensive income.

7. Shareholders' Deficit

On June 27, 2008, HealthSouth finalized the issuance and sale of 8.8 million shares of its common stock to J.P. Morgan Securities Inc. for net proceeds of approximately $150 million. The Company used the net proceeds of the offering primarily for redemption and repayment of short-term and long-term borrowings. See Note 2, *Liquidity*, and Note 6, *Long-term Debt*, for additional information regarding use of the net proceeds.

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The effects of this transaction on the number of our common shares outstanding, *Common stock*, and *Capital in excess of par value* are as follows (in millions):

	Nine Months Ended September 30, 2008	
NUMBER OF COMMON SHARES OUTSTANDING		
Balance at December 31, 2007	78.7	
Issuance of common stock	8.8	
Issuance of restricted stock	0.4	
Purchase or receipt of treasury stock	(0.1)	
Other	0.2	
Balance at September 30, 2008	88.0	
COMMON STOCK		
Balance at December 31, 2007	$	0.9
Issuance of common stock	0.1	
Balance at September 30, 2008	$	1.0
CAPITAL IN EXCESS OF PAR VALUE		
Balance at December 31, 2007	$	2,820.4
Dividends declared on convertible perpetual preferred stock	(19.5)	
Issuance of common stock	150.1	
Stock issuance costs	(0.3)	
Stock issued to employees exercising stock options	0.3	
Stock-based compensation	3.9	
Restricted stock and other plans, less cancellations	0.2	
Amortization of restricted stock	4.6	
Balance at September 30, 2008	$	2,959.7

8. Guarantees:

Primarily in conjunction with the sale of certain facilities, including the sale of our surgery centers, outpatient, and diagnostic divisions during 2007, HealthSouth assigned, or remained as a guarantor on, the leases of certain properties and equipment to certain purchasers and, as a condition of the lease, agreed to act as a guarantor of the purchaser's performance on the lease. HealthSouth also remained as a guarantor to certain purchase and servicing contracts that were assigned to the buyer of our diagnostic division in connection with the sale. Should the purchaser fail to pay the obligations due on these leases or contracts, the lessor or vendor would have contractual recourse against us.

As of September 30, 2008, we were secondarily liable for 131 such guarantees. The remaining terms of these guarantees ranged from one month to 210 months. If we were required to perform under all such guarantees, the maximum amount we would be required to pay approximated $100.4 million.

We have not recorded a liability for these guarantees, as we do not believe it is probable we will have to perform under these agreements. If we are required to perform under these guarantees, we could potentially have recourse against the purchaser for recovery of any amounts paid. In addition, the purchasers of our surgery centers, outpatient, and diagnostic divisions have agreed to seek releases from the lessors and vendors in favor of HealthSouth with respect to the guarantee obligations associated with these divestitures. To the extent the purchasers of these divisions are unable to obtain releases for HealthSouth, the purchasers have agreed to indemnify HealthSouth for damages incurred under the guarantee obligations, if any.

These guarantees are not secured by any assets under the agreements. As of September 30, 2008, we have been required to perform under one such guarantee. Amounts paid under this guarantee were not material to our financial position, results of operations, or cash flows.

9. Assets Held for Sale and Results of Discontinued Operations:

During the three months ended September 30, 2008, we identified one hospital and one gamma knife radiosurgery center that qualified under FASB Statement No. 144 to be reported as assets held for sale and

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discontinued operations. For these facilities, we reclassified our condensed consolidated balance sheet as of December 31, 2007 to show the assets and liabilities of these qualifying facilities as held for sale. We also reclassified our condensed consolidated statements of operations and comprehensive income for the three and nine months ended September 30, 2007 and our condensed consolidated statement of cash flows for the nine months ended September 30, 2007 to show the results of these qualifying facilities as discontinued operations.

The operating results of discontinued operations, including the allocation of $0.3 million and $43.3 million, respectively, of interest expense for the three and nine months ended September 30, 2007 (as discussed in Note 6, *Long-term Debt*), are as follows (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net operating revenues	$ 8.0	$ 44.2	$ 24.7	$ 611.0
Costs and expenses	2.3	39.5	26.4	584.3
Impairments	8.4	1.3	9.0	37.2
(Loss) income from discontinued operations	(2.7)	3.4	(10.7)	(10.5)
(Loss) gain on disposal of assets of discontinued operations	(0.1)	1.6	(0.1)	3.1
Gain of divestitures of divisions	–	40.4	18.7	443.6
Income tax (expense) benefit	–	(7.9)	0.7	37.5
(Loss) income from discontinued operations, net of tax	$ (2.8)	$ 37.5	$ 8.6	$ 473.7

As discussed in Note 13, *Contingencies*, we have recorded charges related to settlements and ongoing negotiations with certain of our current and former subsidiary partnerships related to the restatement of their historical financial statements. The portion of these charges that is attributable to partnerships of our surgery centers division has been included in our results of discontinued operations. No charges were made to partnerships in our outpatient or diagnostic divisions during the periods presented. We have and may continue to incur additional charges related to these ongoing negotiations with our partners and former partners.

As discussed in Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying our 2007 Form 10-K, we insure a substantial portion of our professional liability, general liability, and workers' compensation risks through a self-insured retention program underwritten by our consolidated wholly owned offshore captive insurance subsidiary, HCS, Ltd., which we fund annually. Expenses for retained professional and general liability risks and workers' compensation risks associated with our surgery centers, outpatient, and diagnostic divisions have been included in our results of discontinued operations.

During the three and nine months ended September 30, 2008, we recorded impairment charges of $8.4 million and $9.0 million, respectively. The majority of these charges related to the hospital that qualified to be reported as discontinued operations during the third quarter of 2008. We determined the fair value of the impaired long-lived assets at the hospital primarily based on the assets' estimated fair value using valuation techniques that included third-party appraisals and a preliminary offer from a third party to purchase the assets.

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Assets and liabilities held for sale consist of the following (in millions):

	September 30, 2008	December 31, 2007
Assets:		
Cash and cash equivalents	$ 0.1	$ 0.4
Restricted cash	–	1.6
Accounts receivable, net	2.9	9.6
Other current assets	2.2	7.4
Total current assets	5.2	19.0
Property and equipment, net	12.6	27.4
Goodwill	13.9	48.8
Intangible assets, net	0.3	1.8
Other long-term assets	0.5	–
Total long-term assets	27.3	78.0
Total assets	$ 32.5	$ 97.0
Liabilities:		
Current portion of long-term debt	$ 0.4	$ 0.4
Accounts payable	0.9	2.2
Accrued expenses and other current liabilities	7.3	19.7
Deferred amounts related to sale of surgery centers division	26.5	66.3
Total current liabilities	35.1	88.6
Long-term debt, net of current portion	2.1	2.4
Other long-term liabilities	1.6	1.8
Total long-term liabilities	3.7	4.2
Total liabilities	$ 38.8	$ 92.8

Surgery Centers Division—

The transaction to sell our surgery centers division to ASC Acquisition LLC (“ASC”) closed on June 29, 2007, other than with respect to certain facilities in Connecticut, Rhode Island, and Illinois for which approvals for the transfer to ASC had not yet been received as of such date. The purchase price consisted of cash consideration of $920 million, subject to certain adjustments, and a contingent option to acquire up to a 5% equity interest in the new company. The net cash proceeds received at closing, after deducting deal and separation costs, purchase price adjustments, and approximately $15.5 million of debt assumed by ASC, approximated $860.7 million.

As noted above, the closing of the sale of the surgery centers division occurred on June 29, 2007, other than with respect to certain facilities for which approvals for the transfer to ASC had not yet been received as of such date. In connection with the closing, HealthSouth and ASC agreed, among other things, that HealthSouth would retain its ownership interest in certain surgery centers until regulatory approvals for the transfer of such surgery centers to ASC were received. In that regard, ASC would manage the operations of such surgery centers until such approvals had been received, and HealthSouth and ASC entered into arrangements designed to place them in approximately the same economic position, whether positive or negative, they would have occupied had all regulatory approvals been received prior to closing. Upon receipt of such approvals, HealthSouth’s ownership interest in such facilities would be transferred to ASC. No portion of the purchase price was withheld at closing pending the transfer of these facilities. In the event regulatory approval for the transfer of any such facility is not received prior to June 29, 2009, HealthSouth would be required to return to ASC a portion of the purchase price allocated to such facility.

In August and November 2007, we received approval for the transfer of the applicable facilities in Connecticut and Rhode Island, respectively, but approval for the applicable facilities in Illinois remained pending as of December 31, 2007. On January 28, 2008, we received approval for the change in control of five of the six Illinois facilities. The sixth facility has an outstanding relocation project, and we expect to file the application for change in control for this facility when the relocation project is complete, which is expected to be in the first half of 2009. In the interim, we will maintain our management agreement with ASC with respect to this facility.

During 2007, we also reached an agreement with certain of our remaining partners to sell an additional facility to ASC. This facility was an opt-out partnership at the time the original transaction closed with ASC.

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After deducting deal and separation costs, we received approximately $16.2 million of net cash proceeds in conjunction with the sale of this facility.

The assets and liabilities presented below for the surgery centers division as of September 30, 2008 include the assets and liabilities associated with the facility that had not been transferred as of September 30, 2008, as these assets will not be transferred until approval for such transfer is obtained. The assets and liabilities presented below for the surgery centers division as of December 31, 2007 include the assets and liabilities associated with the facilities that had not been transferred as of that date. As of September 30, 2008, we have deferred approximately $26.5 million of cash proceeds received at closing associated with the facility that was awaiting regulatory approval for the transfer to ASC as of September 30, 2008. We will continue to report the results of operations of this facility in discontinued operations until the transfer of the facility occurs.

The assets and liabilities of the surgery centers division reported as held for sale consist of the following (in millions):

	September 30, 2008		**December 31, 2007**	
Assets:				
Cash and cash equivalents	$	–	$	0.4
Restricted cash	–		0.2	
Accounts receivable, net	0.5		2.6	
Other current assets	0.5		2.0	
Total current assets	1.0		5.2	
Property and equipment, net	3.6		9.1	
Goodwill	13.9		48.8	
Intangible assets, net	0.4		1.9	
Other long-term assets	0.1		1.1	
Total long-term assets	18.0		60.9	
Total assets	$	19.0	$	66.1
Liabilities:				
Current portion of long-term debt	$	0.4	$	0.4
Accounts payable	0.3		1.3	
Accrued expenses and other current liabilities	0.8		5.8	
Deferred amounts related to sale of surgery centers division	26.5		66.3	
Total current liabilities	28.0		73.8	
Long-term debt, net of current portion	2.1		2.4	
Other long-term liabilities	0.1		0.3	
Total long-term liabilities	2.2		2.7	
Total liabilities	$	30.2	$	76.5

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The operating results of the surgery centers division included in discontinued operations consist of the following (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net operating revenues	$ 2.2	$ 12.0	$ 8.5	$ 373.1
Costs and expenses	2.0	10.6	11.9	345.6
Impairments	0.3	0.8	0.9	3.8
(Loss) income from discontinued operations	(0.1)	0.6	(4.3)	23.7
(Loss) gain on disposal of assets of discontinued operations	–	(0.1)	0.1	1.8
Gain on divestiture of division	–	49.2	19.3	317.8
Income tax (expense) benefit	–	(6.3)	0.7	42.2
(Loss) income from discontinued operations, net of tax	$ (0.1)	$ 43.4	$ 15.8	$ 385.5

As a result of the disposition of our surgery centers division, we recorded a $329.9 million post-tax gain in the second quarter of 2007, a $49.2 million post-tax gain during the third quarter of 2007, and a $2.8 million post-tax loss during the fourth quarter of 2007, for a total post-tax gain on disposal of approximately $376.3 million during the year ended December 31, 2007. During the first quarter of 2008, we recorded a $19.3 million post-tax gain on disposal associated with the five Illinois facilities that were transferred during the quarter. We expect to record an additional post-tax gain of approximately $10 million to $16 million for the facility that remains pending in Illinois.

In connection with the divestiture of our surgery centers division, we entered into a transition services agreement (“TSA”) with ASC whereby we continued to provide back-office services, primarily related to certain information technology and accounting services, related to the operations of our surgery centers division. This TSA expired in June 2008. The compensation we received related to these services was not material to either HealthSouth or the operations of the surgery centers division.

Outpatient Division—

The transaction to sell our outpatient rehabilitation division to Select Medical Corporation (“Select Medical”) closed on May 1, 2007, other than with respect to certain facilities for which approvals for the transfer to Select Medical had not yet been received as of such date. In connection with the closing of the sale of this division, we entered into a letter agreement with Select Medical whereby we agreed, among other things, we would retain certain outpatient facilities until certain state regulatory approvals for the transfer of such facilities to Select Medical were received. In that regard, we entered into agreements with Select Medical whereby Select Medical managed certain operations of the applicable facilities until such approvals were received. Approximately $24 million of the $245 million purchase price was withheld pending the transfer of these facilities. The net cash proceeds received at closing, after deducting deal and separation costs, purchase price adjustments, and approximately $3.2 million of debt assumed by Select Medical, approximated $200.4 million. Subsequent to closing, we received approval and transferred the remaining facilities to Select Medical, and we received additional sale proceeds in November 2007.

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The assets and liabilities of the outpatient division reported as held for sale as of September 30, 2008 and December 31, 2007 were not material. The operating results of the outpatient division included in discontinued operations consist of the following (in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008		**2007**		**2008**		**2007**	
Net operating revenues	$	0.1	$	12.7	$	1.4	$	120.5
Costs and expenses	(5.1)		5.5		(3.1)		106.0	
Impairments	–		–		–		0.2	
Income from discontinued operations	5.2		7.2		4.5		14.3	
Loss on disposal of assets of discontinued Operations	–		–		–		(1.3)	
(Loss) gain on divestiture of division	–		(0.4)		–		134.2	
Income tax expense	–		(3.1)		–		(7.4)	
Income from discontinued operations, net of tax	$	5.2	$	3.7	$	4.5	$	139.8

Amounts included in income from discontinued operations of our outpatient division in the three and nine months ended September 30, 2008 primarily relate to the expiration of a contingent liability associated with a prior contractual agreement associated with the division.

As a result of the disposition of our outpatient division, we recorded a $135.0 million post-tax gain in the second quarter of 2007, a $0.4 million post-tax loss in the third quarter of 2007, and a $11.1 million post-tax gain in the fourth quarter of 2007, for a total post-tax gain of $145.7 million during the year ended December 31, 2007.

Diagnostic Division—

During 2007, we entered into an agreement with The Gores Group to sell our diagnostic division. This transaction closed on July 31, 2007, other than with respect to one facility for which approval for the transfer had not yet been received as of such date. The net cash proceeds received at closing, after deducting deal and separation costs and purchase price adjustments, approximated $39.7 million. During the first quarter of 2008, we received approval for the transfer of the remaining facility to The Gores Group.

The assets and liabilities of the diagnostic division reported as held for sale as of September 30, 2008 and December 31, 2007 were not material. The operating results of the diagnostic division included in discontinued operations consist of the following (in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008		**2007**		**2008**		**2007**	
Net operating revenues	$	–	$	13.5	$	1.0	$	90.2
Costs and expenses	0.3		14.4		2.7		96.6	
Impairments	0.4		0.5		0.4		33.2	
Loss from discontinued operations	(0.7)		(1.4)		(2.1)		(39.6)	
Gain on disposal of assets of discontinued Operations	–		1.5		–		2.8	
Loss on divestiture of division	–		(8.4)		(0.6)		(8.4)	
Income tax benefit	–		1.2		–		2.2	
Loss from discontinued operations, net of tax	$	(0.7)	$	(7.1)	$	(2.7)	$	(43.0)

During the first quarter of 2007, we wrote the intangible assets and certain long-lived assets of our diagnostic division down to their estimated fair value based on the estimated net proceeds to be received from the divestiture of the division. This charge is included in impairments in the above results of operations of our diagnostic division for the nine months ended September 30, 2007. As a result of the disposition of our diagnostic division, we recorded an approximate $8.4 million post-tax loss in the third quarter of 2007 and a $0.1 million post-tax gain in the fourth quarter of 2007, for a total post-tax loss of approximately $8.3 million during the

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year ended December 31, 2007. This loss primarily resulted from working capital adjustments based on the final balance sheet. During the first quarter of 2008, we recorded an approximate $0.5 million post-tax loss on disposal associated with the remaining facility that received approval for the transfer to The Gores Group during the first quarter of 2008.

In connection with the divestiture of our diagnostic division, we entered into a TSA with an affiliate of The Gores Group whereby we continued to provide back-office services, primarily related to communications support services, related to the operations of our diagnostic division. We also entered into an agreement whereby an affiliate of The Gores Group provided certain services related to the accounts receivable and other assets of operations we retained. Both agreements expired during 2008. The compensation we paid and received related to these services was not material to either HealthSouth or the operations of the diagnostic division.

10. Income Taxes:

In the third quarter of 2008, we settled all federal income tax issues outstanding with the IRS for the tax years 2000 through 2003, and the Joint Committee of Congress reviewed and approved the associated income tax refunds due to the Company. In October 2008, the Company received a total cash refund of approximately $46 million, including $33 million of federal income tax refunds and $13 million of associated interest. Approximately $33 million of this federal income tax recovery was used to pay down long-term debt, as discussed in Note 6, *Long-term Debt*.

Our *Provision for income tax benefit* of $22.5 million for the three months ended September 30, 2008, includes the following: (1) current income tax expense of approximately $2.0 million attributable to state income tax expense of subsidiaries which have separate state filing requirements and federal income taxes for subsidiaries not included in our federal consolidated income tax return and (2) deferred income tax expense of approximately $0.6 million attributable to increases in the basis difference of certain indefinite-lived assets offset by (3) current income tax benefit of approximately $25.1 million primarily attributable to state income tax refunds received, or expected to be received, and changes in the amount of unrecognized tax benefits, as discussed below.

Our *Provision for income tax benefit* of $21.7 million for the nine months ended September 30, 2008, includes the following: (1) current income tax expense of approximately $20.5 million attributable to a revision in previously estimated federal income tax refunds and related interest as a result of our settlement with the IRS for the tax years 2000 through 2003, state income tax expense of subsidiaries which have separate state filing requirements, and federal income taxes for subsidiaries not included in our federal consolidated income tax return and (2) deferred income tax expense of approximately $2.0 million attributable to increases in the basis difference of certain indefinite-lived assets offset by (3) current income tax benefit of approximately $44.2 million primarily attributable to state income tax refunds received, or expected to be received, and changes in the amount of unrecognized tax benefits, as discussed below.

We have significant federal and state net operating losses. We assess the realization of our deferred tax assets quarterly to determine whether an adjustment to our valuation allowance is required. After consideration of all evidence, both positive and negative, management concluded it is more likely than not we will not realize a portion of our deferred tax assets. Therefore, a valuation allowance has been established on substantially all of our net deferred tax assets. No valuation allowance has been provided on deferred assets and liabilities attributable to subsidiaries not included within the federal consolidated group.

Our *Provision for income tax benefit* of $281.2 million and $288.2 million for the three and nine months ended September 30, 2007, respectively, consists of the following: (1) a current income tax benefit of $251.0 million and $252.8 million, respectively, the majority of which is attributable to our settlement of federal income taxes, including interest, for the years 1996 to 1999 in excess of the estimated amounts previously accrued (as discussed in Note 17, *Income Taxes*, to the consolidated financial statements accompanying our 2007 Form 10-K), (2) a current income tax benefit of $24.4 million, in both periods, due to a change in estimate of the Company’s state taxable income due to the IRS adjustments for the 1996 through 1999 period, (3) a current income tax benefit of $10.4 million and $22.7 million, respectively, attributable to the utilization of the period’s pre-tax loss from continuing operations to offset the gains attributable to the sale of the surgery centers and outpatient divisions (see Note 9, *Assets Held for Sale and Results of Discontinued Operations*), (4) current income tax expense of $3.7 million and $9.0 million, respectively, attributable to state income taxes of subsidiaries which have separate tax filing requirements, income taxes for other subsidiaries that are not included in our

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federal consolidated income tax return, and federal alternative minimum tax liabilities, and (5) deferred income tax expense of $0.9 million and $2.7 million, respectively, attributable to subsidiaries that are not included in our federal consolidated income tax return and increases in the basis difference of certain indefinite-lived intangible assets.

We adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. FASB Interpretation No. 48 clarifies the application of FASB Statement No. 109, *Accounting for Income Taxes*, by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in a company's financial statements. As a result of our adoption of FASB Interpretation No. 48, we recognized a $4.2 million increase to reserves for uncertain tax positions. This increase was accounted for as an addition to *Accumulated deficit* as of January 1, 2007. Including the cumulative effect increase to the reserves for uncertain tax positions, as of January 1, 2007, we had approximately $267.4 million of total gross unrecognized tax benefits, of which approximately $247.0 million would affect our effective tax rate if recognized. The amount of the unrecognized tax benefits changed significantly during the year ended December 31, 2007 due to the settlement with the IRS for the tax years 1996 through 1999, as discussed above and in Note 17, *Income Taxes*, to the consolidated financial statements accompanying our 2007 Form 10-K.

As of December 31, 2007, total remaining gross unrecognized tax benefits were $138.2 million, all of which would affect our effective tax rate if recognized. Total accrued interest expense related to unrecognized tax benefits was $11.7 million as of December 31, 2007. The amount of unrecognized tax benefits changed during the second quarter of 2008 due to the settlement of state income tax refund claims with certain states for tax years 1996 through 1999 and the settlement with the IRS for tax years 2000 through 2003, as discussed above. The amount of unrecognized tax benefits changed during the third quarter of 2008 due to the filing of amended income tax returns for tax years 1995 through 1999 with the IRS, non-unitary state claims for tax years 2000 through 2003, and the running of the statute of limitations on certain state claims. Total remaining gross unrecognized tax benefits were $79.2 million as of September 30, 2008, all of which would affect our effective tax rate if recognized. Total accrued interest expense related to unrecognized tax benefits at September 30, 2008 was $10.2 million.

A reconciliation of the change in our unrecognized tax benefits from December 31, 2007 to September 30, 2008 is as follows (in millions):

	Gross Unrecognized Income Tax Benefits		Accrued Interest and Penalties	
Balance at December 31, 2007	$	138.2	$	11.7
Gross amount of increases in unrecognized tax benefits related to prior periods	0.1		0.3	
Gross amount of decreases in unrecognized tax benefits related to prior periods	(2.6)		–	
Balance at March 31, 2008	135.7		12.0	
Gross amount of increases in unrecognized tax benefits related to prior periods	0.2		0.9	
Gross amount of decreases in unrecognized tax benefits related to prior periods	(11.1)		–	
Decreases in unrecognized tax benefits relating to settlements with taxing authorities	(47.6)		–	
Balance at June 30, 2008	77.2		12.9	
Gross amount of increases in unrecognized tax benefits related to prior periods	14.3		0.1	
Gross amount of decreases in unrecognized tax benefits related to prior periods	(10.0)		(0.7)	
Reduction to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations	(2.3)		(2.1)	
Balance at September 30, 2008	$	79.2	$	10.2

Our continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. For the three months ended September 30, 2008, we recorded $0.7 million of interest income as part of our income tax provision. During the nine months ended September 30, 2008, we recorded $2.1 million of

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interest expense as part of our income tax provision. For the three and nine months ended September 30, 2007, we recorded $125.0 million and $126.8 million, respectively, of interest income as part of our income tax provision. Total accrued interest income was $17.3 million and $19.5 million as of September 30, 2008 and December 31, 2007, respectively.

HealthSouth and its subsidiaries' federal and state income tax returns are periodically examined by various regulatory taxing authorities. In connection with such examinations, we settled federal income tax examinations with the IRS for all tax years through 2003, including receipt of the applicable cash refund for tax years 1996 through 1999 in October 2007 and receipt of the applicable cash refund for tax years 2000 through 2003 in October 2008.

For the tax years that remain open under the applicable statutes of limitations, amounts related to these unrecognized tax benefits have been considered by management in its estimate of our potential net recovery of prior years' income taxes. However, at this time, we cannot estimate a range of the reasonably possible change that may occur.

We continue to actively pursue the maximization of our remaining income tax refund claims. The process of resolving these tax matters with the applicable taxing authorities will continue throughout 2008, and will likely extend into 2009. Although management believes its estimates and judgments related to these claims are reasonable, depending on the ultimate resolution of these tax matters, actual amounts recovered could differ from management's estimates, and such differences could be material.

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11. Earnings per Common Share:

The calculation of earnings per common share is based on the weighted-average number of our common shares outstanding during the applicable period. The calculation for diluted earnings per common share recognizes the effect of all dilutive potential common shares that were outstanding during the respective periods, unless their impact would be antidilutive. The following table sets forth the computation of basic and diluted earnings per common share (in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Basic:				
Numerator:				
Income from continuing operations	$ 9.4	$ 250.1	$ 61.9	$ 225.5
Less: Convertible perpetual preferred stock dividends	(6.5)	(6.5)	(19.5)	(19.5)
Income from continuing operations available to common shareholders	2.9	243.6	42.4	206.0
(Loss) income from discontinued operations, net of tax	(2.8)	37.5	8.6	473.7
Net income available to common shareholders	$ 0.1	$ 281.1	$ 51.0	$ 679.7
Denominator:				
Basic weighted average common shares outstanding	87.4	78.5	81.6	78.6
Basic earnings per common share:				
Income from continuing operations available to common shareholders	$ 0.03	$ 3.10	$ 0.52	$ 2.62
(Loss) income from discontinued operations, net of tax	(0.03)	0.48	0.11	6.03
Net income available to common shareholders	$ 0.00	$ 3.58	$ 0.63	$ 8.65
Diluted:				
Numerator:				
Income from continuing operations	$ 9.4	$ 250.1	$ 61.9	$ 225.5
(Loss) income from discontinued operations, net of tax	(2.8)	37.5	8.6	473.7
Net income available to common shareholders	$ 6.6	$ 287.6	$ 70.5	$ 699.2
Denominator:				
Diluted weighted average common shares outstanding	101.0	91.8	95.1	91.9
Diluted earnings per common share:				
Income from continuing operations	$ 0.03	$ 2.72	$ 0.52	$ 2.45
(Loss) income from discontinued operations, net of tax	(0.03)	0.41	0.11	5.16

Net income available to common shareholders	$	0.00	$	3.13	$	0.63	$	7.61

Diluted earnings per share report the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. These potential shares include dilutive stock options, restricted stock awards, restricted stock units, and convertible perpetual preferred stock. For the three months ended September 30, 2008 and 2007, the number of potential shares approximated 13.6 million and 13.3 million, respectively. For the nine months ended September 30, 2008 and 2007, the number of potential shares approximated 13.5 million and 13.3 million, respectively. For the three and nine months ended September 30, 2008 and 2007, approximately 13.1 million of the potential shares related to our *Convertible perpetual preferred stock*. For the three and nine months ended September 30, 2008, adding back the dividends for the convertible perpetual preferred stock to our *Income from continuing operations available to common shareholders* causes a per share increase when calculating diluted earnings per common share resulting in an

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antidilutive per share amount. Therefore, basic and diluted earnings per common share are the same for the three and nine months ended September 30, 2008.

Options to purchase approximately 2.4 million and 2.6 million shares of common stock were outstanding during the three and nine months ended September 30, 2008 and 2007, respectively, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

In January 2004, we repaid our then-outstanding 3.25% Convertible Debentures using the net proceeds of a loan arranged by Credit Suisse First Boston. In connection with this transaction, we issued warrants to the lender to purchase two million shares of our common stock. Each warrant has a term of ten years from the date of issuance and an exercise price of $32.50 per share. The warrants were not assumed exercised for dilutive shares outstanding because they were antidilutive in the periods presented.

In March 2006, we issued 400,000 shares of convertible perpetual preferred stock as part of a recapitalization of HealthSouth. We use the if-converted method to include the convertible perpetual preferred stock in our computation of diluted earnings per share.

In September 2006, we agreed to issue approximately 5.0 million shares of common stock and warrants to purchase approximately 8.2 million shares of common stock to settle our class action securities litigation. This agreement received final court approval on January 11, 2007. As of September 30, 2008, these shares of common stock and warrants have not been issued and are not included in our basic or diluted common shares outstanding. For additional information, see Note 12, *Securities Litigation Settlement*.

As described in Note 7, *Shareholders' Deficit*, we finalized the issuance and sale of 8.8 million shares of our common stock to J.P. Morgan Securities Inc. on June 27, 2008. The increase in our basic and diluted weighted average common shares outstanding for the three and nine months ended September 30, 2008 compared to the same periods of 2007 is primarily the result of this transaction.

12. Securities Litigation Settlement:

On June 24, 2003, the United States District Court for the Northern District of Alabama consolidated a number of separate securities lawsuits filed against us under the caption *In re HealthSouth Corp. Securities Litigation*, Master Consolidation File No. CV-03-BE-1500-S (the "Consolidated Securities Action"). The Consolidated Securities Action included two prior consolidated cases (*In re HealthSouth Corp. Securities Litigation*, CV-98-J-2634-S and *In re HealthSouth Corp. 2002 Securities Litigation*, Consolidated File No. CV-02-BE-2105-S) as well as six lawsuits filed in 2003. Including the cases previously consolidated, the Consolidated Securities Action comprised over 40 separate lawsuits. The court divided the Consolidated Securities Action into two subclasses:

- Complaints based on purchases of our common stock were grouped under the caption *In re HealthSouth Corp. Stockholder Litigation*, Consolidated Case No. CV-03-BE-1501-S (the "Stockholder Securities Action"), which was further divided into complaints based on purchases of our common stock in the open market (grouped under the caption *In re HealthSouth Corp. Stockholder Litigation,* Consolidated Case No. CV-03-BE-1501-S) and claims based on the receipt of our common stock in mergers (grouped under the caption *HealthSouth Merger Cases*, Consolidated Case No. CV-98-2777-S). Although the plaintiffs in the *HealthSouth Merger Cases* have separate counsel and have filed separate claims, the *HealthSouth Merger Cases* are otherwise consolidated with the Stockholder Securities Action for all purposes.
- Complaints based on purchases of our debt securities were grouped under the caption *In re HealthSouth Corp. Bondholder Litigation*, Consolidated Case No. CV-03-BE-1502-S (the "Bondholder Securities Action").

On January 8, 2004, the plaintiffs in the Consolidated Securities Action filed a consolidated class action complaint. The complaint named us as a defendant, as well as more than 30 of our current and former employees, officers and directors, the underwriters of our debt securities, and our former auditor. The complaint alleged, among other things, (1) that we misrepresented or failed to disclose certain material facts concerning our business and financial condition and the impact of the Balanced Budget Act of 1997 on our operations in order

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to artificially inflate the price of our common stock, (2) that from January 14, 2002 through August 27, 2002, we misrepresented or failed to disclose certain material facts concerning our business and financial condition and the impact of the changes in Medicare reimbursement for outpatient therapy services on our operations in order to artificially inflate the price of our common stock, and that some of the individual defendants sold shares of such stock during the purported class period, and (3) that Richard M. Scrushy, our former chairman and chief executive officer, instructed certain former senior officers and accounting personnel to materially inflate our earnings to match Wall Street analysts' expectations, and that senior officers of HealthSouth and other members of a self-described "family" held meetings to discuss the means by which our earnings could be inflated and that some of the individual defendants sold shares of our common stock during the purported class period. The consolidated class action complaint asserted claims under Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, and claims under Sections 10(b), 14(a), 20(a) and 20A of the Securities Exchange Act of 1934.

On February 22, 2006, we announced we had reached a preliminary agreement in principle with the lead plaintiffs in the Stockholder Securities Action, the Bondholder Securities Action, and the derivative litigation (as discussed in Note 13, *Contingencies*, "Derivative Litigation"), as well as with our insurance carriers, to settle claims filed in those actions against us and many of our former directors and officers. On September 26, 2006, the plaintiffs in the Stockholder Securities Action and the Bondholder Securities Action, HealthSouth, and certain individual former HealthSouth employees and board members entered into and filed a stipulation of partial settlement of this litigation. We also entered into definitive agreements with the lead plaintiffs in these actions and the derivative actions (as discussed in Note 13, *Contingencies*, "Derivative Litigation"), as well as certain of our insurance carriers, to settle the litigation. These settlement agreements memorialized the terms contained in the preliminary agreement in principle entered into in February 2006. On September 28, 2006, the United States District Court entered an order preliminarily approving the stipulation and settlement. Following a period to allow class members to opt out of the settlement and for objections to the settlement to be lodged, the Court held a hearing on January 8, 2007 and determined the proposed settlement was fair, reasonable and adequate to the class members and that it should receive final approval. An order approving the settlement was entered on January 11, 2007. Individual class members representing approximately 205,000 shares of common stock and one bondholder with a face value of $1.5 million elected to be excluded from the settlement. The order approving the settlement bars claims by the non-settling defendants arising out of or relating to the Stockholder Securities Action, the Bondholder Securities Action, and the derivative litigation but does not prevent other security holders excluded from the settlement from asserting claims directly against the Company.

Under the settlement agreements, federal securities and fraud claims brought in the Consolidated Securities Action against us and certain of our former directors and officers were settled in exchange for aggregate consideration of $445 million, consisting of HealthSouth common stock and warrants valued at $215 million and cash payments by HealthSouth's insurance carriers of $230 million. In addition, the settlement agreements provided that the plaintiffs in the Stockholder Securities Action and the Bondholder Securities Action will receive 25% of any net recoveries from future judgments obtained by us or on our behalf with respect to certain claims against Mr. Scrushy (excluding the $48 million judgment against Mr. Scrushy on January 3, 2006, as discussed in Note 13, *Contingencies*, "Derivative Litigation"), Ernst & Young LLP, our former auditor, and UBS Securities, LLC ("UBS Securities"), our former primary investment bank, each of which after this settlement remained a defendant in the derivative actions as well as the Consolidated Securities Action. The settlement agreements were subject to the satisfaction of a number of conditions, including final approval of the United States District Court and the approval of bar orders in the Consolidated Securities Action and the derivative litigation by the United States District Court and the Alabama Circuit Court that would, among other things, preclude certain claims by the non-settling co-defendants against HealthSouth and the insurance carriers relating to matters covered by the settlement agreements. As more fully described in Note 13, *Contingencies*, that approval was obtained on January 11, 2007. The settlement agreements also required HealthSouth to indemnify the settling insurance carriers, to the extent permitted by law, for any amounts they are legally obligated to pay to any non-settling defendants. As of September 30, 2008, we have not recorded a liability regarding these indemnifications, as we do not believe it is probable we will have to perform under the indemnification portion of these settlement agreements, and any amount we would be required to pay is not estimable at this time.

The fund of common stock, warrants, and cash created by settlement of the Consolidated Securities Action (the "Settlement Fund") and the fund created by our payments under the SEC Settlement (the "Disgorgement Fund") (see Note 20, *Settlements*, to the consolidated financial statements accompanying our

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2007 Form 10-K) were the subject of a joint order entered in the United States District Court for the Northern District of Alabama on October 3, 2007. The order approved the form and manner of notice, to be provided to potential claimants of the Settlement Fund and the Disgorgement Fund, regarding the proposed plan of allocation in the Consolidated Securities Action and the distribution plan under the SEC Settlement. Pursuant to the order, eligible claimants could have filed objections to the plan of allocation in the Consolidated Securities Action or the distribution plan under the SEC Settlement on or before December 15, 2007. On February 7, 2008, the court held a joint fairness hearing approving the plan of allocation. The distribution agent is in the process of analyzing the claims for distribution.

Despite approval of the securities class action settlement, there are class members who have elected to opt out of the securities class action settlement and pursue claims individually. In addition, AIG Global Investment Corporation ("AIG"), which failed to opt out of the class settlement on a timely basis, has requested that the court allow it to opt out despite missing the district court's deadline. In the court's Partial Final Judgment and Order of Dismissal with Prejudice dated January 11, 2007, the court found that allowing AIG to opt out after the deadline would result in serious prejudice to us and denied AIG's request for an expansion of time to opt out. On January 26, 2007, AIG moved for reconsideration of the court's decision on this issue. On March 22, 2007, the district court denied AIG's motion for reconsideration. On April 17, 2007, AIG filed a notice of appeal with the Eleventh Circuit Court of Appeals. The appeal has been consolidated with the appeal by Mr. Scrushy of one provision in the bar order in the securities litigation settlement, and has been fully briefed. On March 12, 2008, AIG appealed the plan of allocation for settlement proceeds, and on March 24, 2008, that appeal was consolidated with AIG's appeal of April 17, 2007. On April 18, 2008, AIG dismissed its appeal challenging the plan of allocation. The Eleventh Circuit Court of Appeals has reset the date for oral argument on the Scrushy appeal and the initial AIG appeal for December 11, 2008. If the appellate court were to reverse the district court's denial of AIG's motion for reconsideration and allow AIG to opt out despite missing the deadline, AIG would likely bring individual claims alleging substantial damages relating to the purchase by AIG and its affiliates of HealthSouth bonds. If AIG is not successful with an appeal of that denial, AIG's individual claims would be precluded by the securities class action settlement.

We recorded a charge of $215.0 million as *Government, class action, and related settlements* in our 2005 consolidated statement of operations. During each quarter subsequent to the initial recording of this liability, we reduced or increased our liability for this settlement based on the value of our common stock and the associated common stock warrants underlying the settlement. During the three months ended September 30, 2008, we increased our liability for this settlement by $14.7 million based on the value of our common stock and the associated common stock warrants at quarter end. During the three months ended September 30, 2007, we reduced our liability for this settlement by $5.9 million based on the value of our common stock and the associated common stock warrants at quarter end. During the nine months ended September 30, 2008 and 2007, we reduced our liability for this settlement by $28.6 million and $55.0 million, respectively, based on the value of our common stock and the associated common stock warrants at each period end. The corresponding liability of $131.2 million and $159.8 million as of September 30, 2008 and December 31, 2007, respectively, is included in *Government, class action, and related settlements* in our condensed consolidated balance sheets. The charge for this settlement will continue to be revised in future periods to reflect additional changes in the fair value of the common stock and warrants until they are issued. Distribution of the underlying common stock and warrants to purchase shares of common stock cannot occur until the order described above becomes a final, non-appealable order. At this time, and as noted above, an appeal is outstanding with the Eleventh Circuit Court of Appeals.

In addition, *Government, class action, and related settlements* in our condensed consolidated balance sheets also includes a liability in the amount of $230.0 million in order to state the total liability related to the securities litigation settlement at the aggregate value of the consideration to be exchanged for the securities to be issued by us and the cash to be paid by the insurers. The related receivable from our insurers in the amount of $230.0 million is included in our condensed consolidated balance sheets as *Insurance recoveries receivable*.

13. Contingencies:

Significant Legal Proceedings—

We operate in a highly regulated and litigious industry. As a result, various lawsuits, claims, and legal and regulatory proceedings have been and can be expected to be instituted or asserted against us. The

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resolution of any such lawsuits, claims, or legal and regulatory proceedings could materially and adversely affect our financial position, results of operations, and cash flows in a given period.

Securities Litigation—

See Note 12, *Securities Litigation Settlement*, of these condensed consolidated financial statements and Note 20, *Settlements,* "Securities Litigation Settlement," to the consolidated financial statements accompanying our 2007 Form 10-K for a discussion of the settlement entered into with the lead plaintiffs in certain securities actions.

On November 24, 2004, an individual securities fraud action captioned *Burke v. HealthSouth Corp., et al.*, 04-B-2451 (OES), was filed in the United States District Court of Colorado against us, some of our former directors and officers, and our former auditor. The complaint makes allegations similar to those in the Consolidated Securities Action, as defined in Note 12, *Securities Litigation Settlement*, and asserts claims under the federal securities laws and Colorado state law based on the plaintiff's alleged receipt of unexercised options and the plaintiff's open-market purchases of our stock. By order dated May 3, 2005, the action was transferred to the United States District Court for the Northern District of Alabama, where it remains pending. The plaintiff in this case has not opted out of the Consolidated Securities Action settlement discussed in Note 12, *Securities Litigation Settlement*. Although the deadline for opting out in the Consolidated Securities Action has passed, if the *Burke* action resumes, we will continue to vigorously defend ourselves in this case. However, based on the stage of litigation, and review of the current facts and circumstances, we are unable to determine an amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case should litigation continue or whether any resultant liability would have a material adverse effect on our financial position, results of operations, or cash flows.

Derivative Litigation—

All lawsuits purporting to be derivative complaints filed in the Circuit Court of Jefferson County, Alabama since 2002 have been consolidated and stayed in favor of the first-filed action captioned *Tucker v. Scrushy*, CV-02-5212, filed August 28, 2002. Derivative lawsuits in other jurisdictions have been stayed. The *Tucker* complaint names as defendants a number of former HealthSouth officers and directors. *Tucker* also asserts claims on our behalf against Ernst & Young, UBS entities, as well as against MedCenterDirect.com ("MCD"), Capstone Capital Corp., and G.G. Enterprises. The *Tucker* complaint originally named UBS Group and UBS Investment Bank as defendants. As a result of the UBS defendants' representation that UBS Securities is the proper defendant for all claims asserted in the complaint, UBS Securities is presently the named defendant in *Tucker*.

When originally filed, the primary allegations in the *Tucker* case involved self-dealing by Mr. Scrushy and other insiders through transactions with various entities allegedly controlled by Mr. Scrushy. The complaint was amended four times to add additional defendants and include claims of accounting fraud, improper Medicare billing practices, and additional self-dealing transactions.

On September 26, 2006, certain parties to the *Tucker* litigation entered into and filed a stipulation of settlement. The substantive terms of the settlement are consistent with the preliminary agreement reached in February 2006. Of the $445 million to be paid in accordance with the settlement of the Consolidated Securities Action, $100 million is being credited to the plaintiffs in the *Tucker* litigation. On September 27, 2006, the Alabama Circuit Court entered an order preliminarily approving the stipulation and settlement. The Court held a hearing on January 9, 2007 to determine the fairness, reasonableness, and adequacy of the settlement, whether the settlement should be finally approved by the Court, and to hear and determine any objections to the settlement. The settlement was approved, and an order granting such approval was entered on January 11, 2007. All objections to the settlement were withdrawn, and no individual class members opted out of the settlement.

On October 22, 2008, the Company and the lead derivative stockholder plaintiffs entered into an agreement in principle with UBS Securities and UBS AG, Stamford Branch ("UBS AG"), as well as UBS Securities' insurance carriers, to settle the claims against and by UBS Securities in the *Tucker* litigation. See the "Litigation Against and by UBS" section of this note for additional information.

The *Tucker* derivative claims against Mr. Scrushy, Ernst & Young, and other defendants listed above remain pending and have moved through fact discovery on an expedited schedule that has been coordinated

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with the federal securities claims by former stockholders and bondholders of the Company against Mr. Scrushy and Ernst & Young.

Litigation Against and by Former Independent Auditor—

In March 2003, claims on behalf of HealthSouth were brought in the *Tucker* derivative litigation against Ernst & Young, alleging that from 1996 through 2002, when Ernst & Young served as our independent auditor, Ernst & Young acted recklessly and with gross negligence in performing its duties, and specifically that Ernst & Young failed to perform reviews and audits of our financial statements with due professional care as required by law and by its contractual agreements with us. The claims further allege Ernst & Young either knew of or, in the exercise of due care, should have discovered and investigated the fraudulent and improper accounting practices being directed by Mr. Scrushy and certain other officers and employees, and should have reported them to our board of directors and the Audit Committee. The claims seek compensatory and punitive damages, disgorgement of fees received from us by Ernst & Young, and attorneys' fees and costs. On March 18, 2005, Ernst & Young filed a lawsuit captioned *Ernst & Young LLP v. HealthSouth Corp.*, CV-05-1618, in the Circuit Court of Jefferson County, Alabama. The complaint asserts that the filing of the claims against us was for the purpose of suspending any statute of limitations applicable to those claims. The complaint alleges we provided Ernst & Young with fraudulent management representation letters, financial statements, invoices, bank reconciliations, and journal entries in an effort to conceal accounting fraud. Ernst & Young claims that as a result of our actions, Ernst & Young's reputation has been injured and it has and will incur damages, expense, and legal fees. On April 1, 2005, we answered Ernst & Young's claims and asserted counterclaims related or identical to those asserted in the Tucker action. Upon Ernst & Young's motion, the Alabama state court referred Ernst & Young's claims and HealthSouth's counterclaims to arbitration pursuant to a clause in the engagement agreements between HealthSouth and Ernst & Young. On July 12, 2006, HealthSouth and Tucker filed an arbitration demand on behalf of HealthSouth against Ernst & Young. On August 7, 2006, Ernst & Young filed an answering statement and counterclaim in the arbitration reasserting the claims made in state court. In August 2006, HealthSouth and Tucker agreed to jointly prosecute the claims against Ernst & Young in arbitration.

We are vigorously pursuing our claims against Ernst & Young and defending the claims against us. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case. Fact discovery relating to the claims has concluded on an expedited schedule coordinated with parallel federal securities laws claims by former stockholders and bondholders of HealthSouth against Ernst & Young and with parallel state law claims pending in the Circuit Court of Jefferson County..

Litigation Against and by UBS—

In March 2003, claims on behalf of HealthSouth were brought in the *Tucker* derivative litigation against various UBS entities, alleging that from at least 1998 through 2002, when those entities served as our investment bankers, they breached their duties of care, suppressed information, and aided and abetted in the ongoing fraud. As a result of the UBS defendants' representation that UBS Securities is the proper defendant for all claims asserted in the complaint, UBS Securities is presently the named defendant in *Tucker*. The claims allege that while the UBS entities were fiduciaries of HealthSouth, they became part of a conspiracy to artificially inflate the market price of HealthSouth stock. The complaint seeks compensatory and punitive damages, disgorgement of fees received from us by UBS entities, and attorneys' fees and costs. On August 3, 2005, UBS Securities filed counterclaims against us. Those claims include fraud, misrepresentation, negligence, breach of contract, and indemnity against us for allegedly providing UBS Securities with materially false information concerning our financial condition to induce UBS Securities to provide investment banking services. UBS Securities' counterclaims seek compensatory and punitive damages and a judgment declaring that HealthSouth is liable for any losses, costs, or fees incurred by UBS Securities in connection with its defense of actions relating to the services UBS Securities provided to us. In August 2006, HealthSouth and *Tucker* agreed to jointly prosecute the claims against UBS Securities in state court.

Additionally, on September 6, 2007, UBS AG filed an action against us in the Supreme Court of the State of New York, captioned *UBS AG, Stamford Branch v. HealthSouth Corporation*, Index No. 602993/07, based on the terms of a credit agreement with MCD (the "New York action"). Prior to ceasing operations in 2003, MCD provided certain services to us relating to the purchase of equipment and supplies. We also previously owned 20.2% of MCD's equity securities. During 2003, UBS AG called its loan to MCD. In the New York action, UBS

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AG alleged HealthSouth was the guarantor of the loan and sought recovery of the $20 million principal of its loan to MCD and approximately $8.7 million in interest. However, UBS Securities filed an Answer and Counterclaim in the *Tucker* derivative litigation admitting that it funded the $20 million loan to MCD. On October 1, 2007, HealthSouth removed UBS AG's case from New York state court to federal court in the Southern District of New York, which assigned it Case No. 07 cv 8490. On December 17, 2007, UBS AG moved for summary judgment on its claim under the guarantee provisions of the credit agreement with MCD. On January 18, 2008, HealthSouth filed its opposition to UBS AG's motion for summary judgment, and filed a cross-motion requesting the action be dismissed or stayed in deference to the *Tucker* derivative litigation, which alleged, among other claims, the loan by UBS AG to MCD was part of a scheme between former disloyal officers at the Company, including Mr. Scrushy, and UBS AG to siphon money from the Company.

On November 16, 2007, after HealthSouth removed UBS AG's action from New York state court to New York federal court, UBS Securities filed an Amended Answer in the *Tucker* derivative litigation in Alabama seeking to change its earlier representation in that litigation that it, UBS Securities, made the loan to MCD. Instead, UBS Securities asserted in its Amended Answer that UBS AG made the loan to MCD. The Alabama court struck UBS Securities' Amended Answer in the*Tucker* derivative litigation and gave UBS Securities 30 days to amend its counterclaim to assert a breach of the MCD loan agreement in that litigation, or, alternatively, granted UBS AG permission to intervene in the *Tucker* derivative litigation within 30 days of the order to assert claims for breach of the MCD credit agreement. On March 24, 2008, UBS Securities petitioned the Alabama Supreme Court for writs of mandamus and prohibition to set aside the Alabama court's February 19, 2008 order, as amended on March 7, 2008. On April 23, 2008, the Alabama Supreme Court denied the petition for writs of mandamus. On April 7, 2008, pursuant to the February 19, 2008 order, as amended on March 7, 2008, UBS Securities amended its counterclaim in the *Tucker* derivative litigation so as to add claims against HealthSouth for breach of the MCD credit agreement.

In the New York action, the court issued an order on June 6, 2008 granting UBS AG's motion for summary judgment and denying HealthSouth's motion to dismiss or stay. Following the entry of an initial judgment in the incorrect amount, the court entered an amended judgment on June 16, 2008 in the amount of approximately $30.3 million in favor of UBS AG and against HealthSouth. HealthSouth moved the court to waive the requirement of a bond for security pending appeal, but in an order issued June 17, 2008, the court refused. On June 30, 2008, however, upon agreement of the parties, the court authorized HealthSouth to issue a letter of credit in the amount of $33.6 million (i.e., 111% of the amended judgment) in lieu of a bond. HealthSouth filed its notice of appeal to the U.S. Court of Appeals for the Second Circuit on July 7, 2008. As described below, as part of the agreement with UBS Securities in the *Tucker* derivative litigation, this appeal will be dismissed and the judgment will be satisfied and released.

As discussed above, on October 22, 2008, the Company and the lead derivative stockholder plaintiffs entered into an agreement in principle with UBS Securities and UBS AG, as well as UBS Securities' insurance carriers, to settle litigation filed by the derivative plaintiffs on the Company's behalf in the *Tucker* derivative litigation. Because *Tucker* is a derivative action, this settlement agreement is subject to approval of the court and HealthSouth estimates that the process for approval will take approximately 60 days from the date of the agreement in principle. Under the settlement, HealthSouth will receive $100 million in cash and a release of all claims by the UBS entities, including the release and satisfaction of the judgment in favor of UBS AG in the New York action. HealthSouth will be obligated to pay the reasonable fees of the derivative plaintiffs' attorneys to be approved by the court. After deducting all of the Company's costs and expenses, the Company will pay, pursuant to the settlement agreements in the Consolidated Securities Action (as discussed in Note 12, *Securities Litigation Settlement*) 25% of the net proceeds to those plaintiffs. The settlement does not affect the Company's claims against Richard Scrushy or any other defendants in the*Tucker* derivative litigation, or against the Company's former independent auditor, Ernst & Young, which remain pending in arbitration.

Litigation Against and by Richard M. Scrushy—

After the dismissal of several lawsuits filed against us by Mr. Scrushy, on December 9, 2005, Mr. Scrushy filed a complaint in the Circuit Court of Jefferson County, Alabama, captioned *Scrushy v. HealthSouth*, CV-05-7364. The complaint alleged that, as a result of Mr. Scrushy's removal from the position of chief executive officer in March 2003, we owed him "in excess of $70 million" pursuant to an employment agreement dated as of September 17, 2002. On December 28, 2005, HealthSouth counterclaimed against Mr. Scrushy, asserting claims for breaches of fiduciary duty and fraud arising out of Mr. Scrushy's tenure at

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HealthSouth, and seeking compensatory damages, punitive damages, and disgorgement of wrongfully obtained benefits. Both the claims by Mr. Scrushy and HealthSouth's counterclaims remain pending in Circuit Court. The Company also asserted that the employment agreement with Mr. Scrushy is void and unenforceable.

On or about December 19, 2005, Mr. Scrushy filed a demand for arbitration with the American Arbitration Association pursuant to an indemnity agreement with us. The arbitration demand sought to require us to pay expenses which he estimated exceeded $31 million incurred by Mr. Scrushy, including attorneys' fees, in connection with the defense of criminal fraud claims against him and in connection with a preliminary hearing in the SEC litigation.

On October 17, 2006, the arbitrator issued a final award of approximately $17.0 million to Mr. Scrushy and further ruled that Mr. Scrushy was entitled to payment by HealthSouth of approximately $4.0 million in pre-judgment interest and attorneys' fees and expenses incurred by Scrushy in connection with the arbitration proceeding. On August 31, 2006, HealthSouth and the *Tucker* plaintiffs filed a joint motion in the *Tucker* case to offset the entire award to Mr. Scrushy in the arbitration, including fees and interest, against the approximately $48 million judgment against Mr. Scrushy in *Tucker* for repayment of his bonuses. Mr. Scrushy opposed that effort, and on October 17, 2006 filed a lawsuit captioned *Scrushy v. HealthSouth Corporation*, CA No. 2483-N, in the Delaware Court of Chancery for New Castle County seeking confirmation of the arbitration award in that court. A settlement was reached with Mr. Scrushy by which he agreed to an offset of the arbitrator's award in the amount of $21.5 million, which amount is included in the amount collected from Mr. Scrushy on the *Tucker* judgment. We accrued an estimate of these legal fees as part of *Professional fees—accounting, tax, and legal* in our December 31, 2005 and 2004 consolidated statements of operations. While the arbitrator's ruling provided that we may have an obligation to indemnify Mr. Scrushy for certain costs associated with ongoing litigation, the court's order approving the settlement of the securities litigation prohibits Mr. Scrushy from seeking indemnity or contribution in the securities class action. This order has been appealed by Mr. Scrushy. As of September 30, 2008 and December 31, 2007, an estimate of these legal fees is included in *Accrued expenses and other current liabilities* in our condensed consolidated balance sheets.

Certain Regulatory Actions—

The False Claims Act, 18 U.S.C. § 287, allows private citizens, called "relators," to institute civil proceedings alleging violations of the False Claims Act. These *qui tam* cases are sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government, and the presiding court. It is possible that *qui tam* lawsuits have been filed against us and that we are unaware of such filings or have been ordered by the presiding court not to discuss or disclose the filing of such lawsuits. We may be subject to liability under one or more undisclosed qui tam cases brought pursuant to the False Claims Act.

General Medicine Action—

On August 16, 2004, General Medicine, P.C. ("General Medicine") filed a lawsuit against us captioned *General Medicine, P.C. v. HealthSouth Corp.* seeking the recovery of allegedly fraudulent transfers involving assets of Horizon/CMS Healthcare Corporation ("Horizon/CMS"), a former subsidiary of HealthSouth. The lawsuit was filed in the Circuit Court of Shelby County, Alabama, but was transferred to the Circuit Court of Jefferson County, Alabama on February 28, 2005, where it was assigned case number CV-05-1483.

The underlying claim against Horizon/CMS originates from a services contract entered into in 1995 between General Medicine and Horizon/CMS whereby General Medicine agreed to provide medical director services to skilled nursing facilities owned by Horizon/CMS for a term of three years. Horizon/CMS terminated the agreement six months after it was executed, and General Medicine then initiated a lawsuit in the United States District Court for the Eastern District of Michigan in 1996 (the "Michigan Action"). General Medicine's complaint in the Michigan Action alleged that Horizon/CMS breached the services contract by wrongfully terminating General Medicine. HealthSouth is informed that, at the time of the termination, General Medicine was providing services to two skilled nursing facilities owned by Horizon/CMS. HealthSouth acquired Horizon/CMS in 1997 and sold it to Meadowbrook Healthcare, Inc. ("Meadowbrook") in 2001 pursuant to a stock purchase agreement. In 2004, Meadowbrook consented to the entry of a final judgment in the Michigan Action in the amount of $376 million (the "Consent Judgment") in favor of General Medicine against Horizon/CMS for the alleged wrongful termination of the contract with General Medicine. HealthSouth was not a party to the

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Michigan Action or the settlement negotiated by Meadowbrook. The settlement agreement which was the basis for the Consent Judgment provided that Meadowbrook would pay only $0.3 million to General Medicine to settle the Michigan Action. The settlement agreement further provided that General Medicine would seek to recover the remaining balance of the Consent Judgment solely from HealthSouth.

The complaint filed by General Medicine against HealthSouth alleged that while Horizon/CMS was a wholly owned subsidiary of HealthSouth and General Medicine was an existing creditor of Horizon/CMS, we caused Horizon/CMS to transfer its assets to us for less than a reasonably equivalent value or, in the alternative, with the actual intent to defraud creditors of Horizon/CMS, including General Medicine, in violation of the Alabama Uniform Fraudulent Transfer Act. General Medicine's complaint requested relief including recovery of the unpaid amount of the Consent Judgment, the avoidance of the subject transfers of assets, attachment of the assets transferred to us, appointment of a receiver over the transferred properties, and a monetary judgment for the value of properties transferred. On September 2, 2008, General Medicine filed an amended complaint which alleged that HealthSouth should be held liable for the Consent Judgment under two new theories: fraud and alter ego. Specifically, General Medicine alleged in its amended complaint that HealthSouth, while it was Horizon's parent from 1997 to 2001, failed to observe corporate formalities in its operation and ownership of Horizon, misused its control of Horizon, stripped assets from Horizon, and engaged in other conduct which amounted to a fraud on Horizon's creditors, including General Medicine.

We filed an answer to General Medicine's complaint, as amended, denying liability to General Medicine. We have also asserted counterclaims against General Medicine for fraud, injurious falsehood, tortious interference with business relations, conspiracy, unjust enrichment, and other causes of action. In our counterclaims, we alleged the Consent Judgment is the product of fraud, collusion and bad faith by General Medicine and Meadowbrook and, further, that these parties were guilty of a conspiracy to manufacture a lawsuit against HealthSouth in favor of General Medicine. The case has now entered the discovery stage. We intend to vigorously defend ourselves against General Medicine's claim and to vigorously prosecute our counterclaims against General Medicine.

On October 17, 2008, we filed a motion in the Michigan Action requesting that the court reform the amount of the Consent Judgment to $0.3 million (the amount which Meadowbrook and General Medicine actually agreed would be paid to settle the Michigan Action) or, alternatively, set aside the Consent Judgment because it was the product of fraud on the court and collusion by the parties. Specifically, we assert in the motion that the Consent Judgment was the product of fraud on the court and collusion because, without limitation, (1) General Medicine and Meadowbrook did not inform the Michigan court of the existence or terms of their settlement agreement when they sought to enter their stipulated Consent Judgment; (2) the stipulated Consent Judgment that General Medicine and Meadowbrook submitted to the Michigan court for entry misrepresented the terms of the parties' settlement; (3) the amount of the Consent Judgment was unilaterally selected by General Medicine and was not the product of arms-length negotiations; (4) Meadowbrook's counsel did nothing to test the validity of General Medicine's claim or its alleged damages prior to agreeing to the Consent Judgment; and (5) the $376 million amount of the Consent Judgment was wholly unreasonable and not supported by admissible evidence.

Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or settlement of this case.

Other Litigation—

We have been named as a defendant in two lawsuits brought by individuals in the Circuit Court of Jefferson County, Alabama, *Nichols v. HealthSouth Corp.*, CV-03-2023, filed March 28, 2003, and *Hilsman v. Ernst & Young, HealthSouth Corp., et al.*, CV-03-7790, filed December 12, 2003. The plaintiffs alleged that we, some of our former officers, and our former auditor engaged in a scheme to overstate and misrepresent our earnings and financial position. The plaintiffs sought compensatory and punitive damages. On March 24, 2003, a lawsuit captioned *Warren v. HealthSouth Corp., et al.*, CV-03-5967, was filed in the Circuit Court of Montgomery County, Alabama. The lawsuit, which claimed damages for the defendants' alleged negligence, wantonness, fraud, and breach of fiduciary duty, was transferred to the Circuit Court of Jefferson County, Alabama. Each of these three lawsuits described in this paragraph was consolidated with the *Tucker* case for discovery and other pretrial purposes. The plaintiffs in these cases are subject to the Consolidated Securities Action settlement discussed in Note 12, *Securities Litigation Settlement*, and thereby foreclosed from pursuing these state court

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actions based on purchases made during the class period unless they opted out of that settlement. The plaintiffs in *Warren v. HealthSouth Corp., et al.* did not opt out of the settlement. The plaintiffs in *Hilsman v. Ernst & Young, et al.* attempted to opt out of the settlement, but their election was deemed invalid by the agent. At present, it is unclear whether the plaintiffs in the *Hilsman* action will challenge this determination. The *Nichols* lawsuit asserts claims on behalf of a number of plaintiffs, all but three of whom opted out of the settlement. John Kapoor, who claimed to have purchased over 900,000 shares of stock, attempted to opt-out, but his attempt was deemed invalid by the court. It is unclear whether Mr. Kapoor will challenge this determination. The remaining *Nichols* plaintiffs that opted out of the settlement claimed losses of approximately $5.4 million. The Nichols case remains stayed in Circuit Court. We intend to vigorously defend ourselves in these cases. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of these cases.

HealthSouth has been named as a defendant in two related lawsuits arising from its operation of the former Lloyd Noland Hospital, later renamed HealthSouth Metro West Hospital, styled *The Lloyd Noland Foundation, Inc. v. Tenet Healthcare Corp. v. HealthSouth Corporation*, Case No. 2:01-cv-0437-KOB in the United States District for the Northern District of Alabama (the "Federal Case"), filed February 16, 2001, and *The Lloyd Noland Foundation v. HealthSouth Corporation*, Case No. CV-2004-1638 in the Circuit Court for Jefferson County, Alabama, Bessemer Division (the "Bessemer Case"), filed in Jefferson County on August 27, 2004, and transferred to the Jefferson County, Bessemer Division on December 1, 2004. Tenet Healthcare Corporation ("Tenet") asserted third party indemnity claims against HealthSouth in the Federal Case on July 3, 2001.

In 1996, The Lloyd Noland Foundation (the "Foundation") sold the Lloyd Noland Hospital to a subsidiary of Tenet HealthCare Corporation for approximately $50 million. Under the terms of the related agreement (the "Tenet Agreement"), Tenet agreed to resell 120 acute care beds to the Foundation for $1.00, upon demand, and to administer the Lloyd Noland Retiree Medical Discount Program. Tenet further agreed to require any subsequent purchaser of the hospital to assume these obligations to the Foundation.

In 1999, three years after the Foundation sold the hospital to Tenet, Tenet sold the hospital assets to the City of Fairfield Healthcare Authority ("Fairfield") for approximately $10 million. Fairfield provided a promissory note to Tenet for the purchase price and HealthSouth guaranteed Fairfield's repayment of the note. Fairfield was unable to repay the note in the original time allotted, and the parties entered into a six-month extension agreement for repayment. In the extension agreement, HealthSouth agreed to indemnify Tenet for any liability to the Foundation arising from the obligations concerning the 120 acute care beds and the Retiree Medical Discount Program.

Fairfield subsequently denied any contractual obligation to resell the acute care beds or administer the Retiree Medical Discount Program, and in February 2000 initiated litigation in the Circuit Court of Montgomery County, Alabama, to obtain a judgment declaring that any such obligation was void. On appeal from rulings in the Montgomery County Case adverse to the Foundation, the Alabama Supreme Court held that the Tenet Agreement "clearly and unambiguously provides that Fairfield assumed the obligations of Tenet [Medical]." Prior to that ruling, however, the Foundation had initiated the Federal Case against Tenet, seeking damages arising from Fairfield's conduct. Tenet then asserted an indemnity claim against HealthSouth via a third party complaint. Fairfield eventually sold all of the requested beds at issue to the Foundation after the Alabama Supreme Court delivered its opinion, but the Foundation now claims to have suffered significant lost earnings as a result of the delay.

HealthSouth purchased the hospital from Fairfield in 2003, but closed the failing hospital in September 2004. Just before the hospital closed, the Foundation initiated the Bessemer Case, this time making a direct claim against HealthSouth for alleged damages relating to Fairfield's prior refusal to resell the beds and failure to administer the Retiree Medical Discount Program.

On November 9, 2004, the trial judge entered summary judgment in favor of HealthSouth on the indemnification issue, finding that the indemnity obligations had expired. After two appeals by Tenet, on June 17, 2008, the Eleventh Circuit Court of Appeals reversed the trial judge's order and found that HealthSouth was not entitled to summary judgment and vacated the trial court's order dismissing Tenet's third party complaint against HealthSouth. On September 24, 2008, after remand from the Court of Appeals, the trial judge entered an order granting the summary judgment motion of the Foundation against Tenet and declared that Tenet remained liable for any breaches by Fairfield as to the obligations under the original Tenet Agreement. On the same date, the trial judge also entered an order granting Tenet's motion for summary judgment against HealthSouth

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determining that HealthSouth was liable to Tenet based on the indemnification agreement for any damages the Foundation recovered against Tenet and further held that, to the extent Tenet may be liable to the Foundation, HealthSouth would be obligated to indemnify Tenet.

As a result of these rulings, HealthSouth would be responsible to pay any damages awarded to the Foundation at trial. The Foundation claims damages of approximately $29 million. Both Tenet and HealthSouth deny that the Foundation has suffered any damages and both Tenet and HealthSouth intend to vigorously defend the Foundation's claims for damages. In the Federal Case, the trial to establish the Foundation's damages, if any, is scheduled for December 8, 2008.

The Bessemer Case remains pending, but no trial date has been established.

Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or settlement of the Federal Case or the Bessemer Case.

Other Matters—

It is our obligation as a participant in Medicare and other federal healthcare programs to routinely conduct audits and reviews of the accuracy of our billing systems and other regulatory compliance matters. As a result of these reviews, we have made, and will continue to make, disclosures to the United States Department of Health and Human Services Office of Inspector General ("HHS-OIG") relating to amounts we suspect represent over-payments from these programs, whether due to inaccurate billing or otherwise. Some of these disclosures have resulted in, or may result in, the Company refunding amounts to Medicare or other federal healthcare programs. On December 14, 2007, we agreed to a final settlement of certain self-disclosures which we made to the HHS-OIG in 2004 and 2005 regarding our relationship with certain physicians. Under the terms of the settlement, we paid, in two installments, a total of $14.2 million to the United States. We recorded $5.0 million of the settlement amount in March 2007, $3.0 million in June 2007, and $6.2 million in September 2007, with each charge included in *Government, class action, and related settlements* in our condensed consolidated statement of operations and comprehensive income for the applicable periods. As of December 31, 2007, we owed approximately $7.1 million under this settlement. This amount is included in *Government, class action, and related settlements* in our condensed consolidated balance sheet as of December 31, 2007. This amount was paid in March 2008.

In connection with the above settlement, we have entered into a second addendum to our corporate integrity agreement (the "CIA") with the HHS-OIG. The original CIA had an effective date of January 1, 2005 and a term of five years from that effective date. The term of both addendums to the CIA is concurrent with our existing five-year CIA. The CIA incorporates compliance program changes, annual audits, and reporting obligations, all of which have been materially complied with on a timely basis. Failure to meet our obligations under our CIA could result in stipulated financial penalties. Failure to comply with material terms, however, could lead to exclusion from further participation in federal healthcare programs, including Medicare and Medicaid, which currently account for a substantial portion of our revenues. See Note 20, *Settlements*, to the consolidated financial statements accompanying our 2007 Form 10-K.

In addition, the reconstruction of our historical financial records resulted in the restatement of not only our 2001 and 2000 consolidated financial statements, but also the financial statements of certain of our subsidiary partnerships, including partnerships of our divested surgery centers division. We have completed settlement negotiations with outside partners in the majority of our inpatient rehabilitation hospital partnerships. However, negotiations continue with certain of our former subsidiary partnerships, primarily within our surgery centers division. We have and may continue to incur additional charges to reduce the economic impact to our former partners.

We also face certain financial risks and challenges relating to our divestiture transactions following their closing. These include indemnification obligations, disputes with former partners (as discussed above), and certain contract termination or repurchase rights that may have been triggered by the divestitures, which in the aggregate could have a material adverse effect on our financial position, results of operations, and cash flows. In addition, we continue to seek regulatory approval for the transition of one surgery center included in the divestiture transactions from the applicable agency.

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14. Condensed Consolidating Financial Information:

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered.” Each of the subsidiary guarantors is 100% owned by HealthSouth, and all guarantees are full and unconditional and joint and several. HealthSouth’s investments in its consolidated subsidiaries, as well as guarantor subsidiaries’ investments in non-guarantor subsidiaries and non-guarantor subsidiaries’ investments in guarantor subsidiaries, are presented under the equity method of accounting.

As described in Note 8, *Long-term Debt*, to the consolidated financial statements accompanying our 2007 Form 10-K, the terms of our Credit Agreement restrict us from declaring or paying cash dividends on our common stock unless: (1) we are not in default under our Credit Agreement and (2) the amount of the dividend, when added to the aggregate amount of certain other defined payments made during the same fiscal year, does not exceed certain maximum thresholds. However, as described in Note 9, *Convertible Perpetual Preferred Stock*, to the consolidated financial statements accompanying our 2007 Form 10-K, our Series A Preferred Stock generally provides for the payment of cash dividends, subject to certain limitations.

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	As of September 30, 2008 HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	$ 12.7	$ 4.1	$ 8.1	$ –	$ 24.9
Restricted cash	32.7	–	40.7	–	73.4
Restricted marketable securities	–	–	27.8	–	27.8
Accounts receivable, net	16.8	146.5	62.7	–	226.0
Insurance recoveries receivable	230.0	–	–	–	230.0
Other current assets	45.6	61.4	57.7	(109.8)	54.9
Current assets held for sale	1.7	18.1	0.4	(15.0)	5.2
Total current assets	339.5	230.1	197.4	(124.8)	642.2
Property and equipment, net	38.7	472.6	165.6	–	676.9
Goodwill	–	250.3	164.1	–	414.4
Intangible assets, net	3.3	35.3	5.9	–	44.5
Investment in and advances to nonconsolidated affiliates	3.2	29.7	9.7	–	42.6
Assets held for sale	0.6	7.8	18.9	–	27.3
Income tax refund receivable	62.9	–	–	–	62.9
Other long-term assets	55.5	205.1	57.2	(248.1)	69.7
Intercompany receivable	1,092.6	–	–	(1,092.6)	–
Total assets	$ 1,596.3	$ 1,230.9	$ 618.8	$ (1,465.5)	$ 1,980.5
Liabilities and Shareholders' (Deficit) Equity					
Current liabilities:					
Current portion of long-term debt	$ 42.3	$ 11.8	$ 1.9	$ –	$ 56.0
Accounts payable	9.6	22.6	8.4	–	40.6
Accrued expenses and other current liabilities	268.5	64.0	53.1	(24.9)	360.7
Government, class action, and related settlements	367.7	–	–	–	367.7
Current liabilities held for sale	30.0	3.8	16.3	(15.0)	35.1
Total current liabilities	718.1	102.2	79.7	(39.9)	860.1
Long-term debt, net of current portion	1,734.7	88.0	29.1	(31.0)	1,820.8
Liabilities held for sale	0.9	0.6	2.2	–	3.7
Other long-term liabilities	101.4	7.3	68.4	(7.1)	170.0
Intercompany payable	–	1,004.5	1,321.4	(2,325.9)	–
	2,555.1	1,202.6	1,500.8	(2,403.9)	2,854.6
Commitments and contingencies					
Minority interest in equity of consolidated affiliates	–	–	84.7	–	84.7
Convertible perpetual preferred stock	387.4	–	–	–	387.4

Shareholders’ (deficit) equity	(1,346.2)	28.3	(966.7)	938.4	(1,346.2)
Total liabilities and shareholders’ (deficit) equity	$ 1,596.3	$ 1,230.9	$ 618.8	$ (1,465.5)	$ 1,980.5

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HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

	As of December 31, 2007 HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	$ 2.0	$ 14.0	$ 9.1	$ (5.3)	$ 19.8
Restricted cash	2.5	–	61.1	–	63.6
Restricted marketable securities	–	–	28.9	–	28.9
Accounts receivable, net	13.1	142.4	62.2	–	217.7
Insurance recoveries receivable	230.0	–	–	–	230.0
Other current assets	63.7	60.7	50.0	(116.0)	58.4
Current assets held for sale	9.4	22.6	1.1	(14.1)	19.0
Total current assets	320.7	239.7	212.4	(135.4)	637.4
Property and equipment, net	87.6	471.2	170.8	–	729.6
Goodwill	–	242.0	164.1	–	406.1
Intangible assets, net	3.1	14.9	8.1	–	26.1
Investment in and advances to nonconsolidated affiliates	3.2	29.5	10.0	–	42.7
Assets held for sale	0.9	17.0	61.4	(1.3)	78.0
Income tax refund receivable	52.5	–	–	–	52.5
Other long-term assets	73.0	205.2	57.2	(257.2)	78.2
Intercompany receivable	1,139.8	–	–	(1,139.8)	–
Total assets	$ 1,680.8	$ 1,219.5	$ 684.0	$ (1,533.7)	$ 2,050.6
Liabilities and Shareholders' Deficit					
Current liabilities:					
Current portion of long-term debt	$ 55.5	$ 11.0	$ 1.8	$ –	$ 68.3
Accounts payable	20.9	19.6	8.2	–	48.7
Accrued expenses and other current liabilities	284.7	59.0	55.6	(35.1)	364.2
Government, class action, and related settlements	400.7	–	–	–	400.7
Current liabilities held for sale	70.4	3.9	28.4	(14.1)	88.6
Total current liabilities	832.2	93.5	94.0	(49.2)	970.5
Long-term debt, net of current portion	1,907.0	77.0	30.5	(40.1)	1,974.4
Liabilities held for sale	0.4	1.1	2.7	–	4.2
Other long-term liabilities	108.3	7.6	63.8	(8.3)	171.4
Intercompany payable	–	1,086.9	1,147.7	(2,234.6)	–
	2,847.9	1,266.1	1,338.7	(2,332.2)	3,120.5
Commitments and contingencies					
Minority interest in equity of consolidated affiliates	–	–	97.2	–	97.2
Convertible perpetual preferred stock	387.4	–	–	–	387.4
Shareholders' deficit	(1,554.5)	(46.6)	(751.9)	798.5	(1,554.5)

Total liabilities and shareholders' deficit	$	1,680.8	$	1,219.5	$	684.0	$	(1,533.7)	$	2,050.6

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HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Balance Sheet

	Three Months Ended September 30, 2008				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net operating revenues	$ 24.0	$ 307.8	$ 133.2	$ (8.8)	$ 456.2
Operating expenses:					
Salaries and benefits	14.7	156.9	67.7	(2.8)	236.5
Other operating expenses	5.3	45.8	21.3	(3.5)	68.9
General and administrative expenses	25.5	–	–	–	25.5
Supplies	1.9	17.4	6.9	–	26.2
Depreciation and amortization	2.8	11.3	4.0	–	18.1
Occupancy costs	1.3	8.8	4.9	(2.2)	12.8
Provision for doubtful accounts	0.4	4.5	1.8	–	6.7
Loss on disposal of assets	0.2	–	–	–	0.2
Government, class action, and related settlements	15.7	–	1.4	–	17.1
Professional fees—accounting, tax, and legal	4.0	–	–	–	4.0
Total operating expenses	71.8	244.7	108.0	(8.5)	416.0
Loss on early extinguishment of debt	2.1	–	–	–	2.1
Interest expense and amortization of debt discounts and fees	37.4	2.2	1.0	(0.2)	40.4
Other expense (income)	0.3	(0.1)	(0.8)	0.2	(0.4)
Loss on interest rate swap	8.0	–	–	–	8.0
Equity in net income of nonconsolidated affiliates	(0.8)	(2.0)	0.1	–	(2.7)
Equity in net income of consolidated affiliates	(25.4)	(3.7)	(0.5)	29.6	–
Minority interests in earnings of consolidated affiliates	–	–	5.9	–	5.9
Management fees	(20.7)	15.5	5.2	–	–
(Loss) income from continuing operations before income tax (benefit) expense	(48.7)	51.2	14.3	(29.9)	(13.1)
Provision for income tax (benefit) expense	(56.3)	25.3	8.5	–	(22.5)
Income from continuing operations	7.6	25.9	5.8	(29.9)	9.4
(Loss) income from discontinued operations, net of income tax expense	(1.0)	(5.3)	3.2	0.3	(2.8)
Net income	$ 6.6	$ 20.6	$ 9.0	$ (29.6)	$ 6.6

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Balance Sheet

	Three Months Ended September 30, 2007				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net operating revenues	$ 22.9	$ 287.6	$ 130.1	$ (12.3)	$ 428.3
Operating expenses:					
Salaries and benefits	13.3	142.3	61.6	(2.8)	214.4
Other operating expenses	2.7	40.3	27.5	(6.8)	63.7
General and administrative expenses	25.8	–	–	–	25.8
Supplies	1.8	16.0	6.3	–	24.1
Depreciation and amortization	4.9	10.4	4.2	–	19.5
Impairment of long-lived assets	0.4	–	–	–	0.4
Occupancy costs	1.3	9.3	4.7	(2.4)	12.9
Provision for doubtful accounts	0.2	4.6	0.8	–	5.6
Loss on disposal of assets	0.3	0.3		–	0.6
Government, class action, and related settlements	4.3	(0.4)	–	–	3.9
Professional fees—accounting, tax, and legal	9.1	0.1	–	–	9.2
Total operating expenses	64.1	222.9	105.1	(12.0)	380.1
Loss on early extinguishment of debt	2.2	–	–	–	2.2
Interest expense and amortization of debt discounts and fees	57.3	2.1	1.0	(0.2)	60.2
Other income	(8.5)	(0.1)	(1.0)	0.2	(9.4)
Loss on interest rate swap	21.4	–	–	–	21.4
Equity in net income of nonconsolidated affiliates	(0.6)	(1.6)	(0.1)	–	(2.3)
Equity in net income of consolidated affiliates—					
Gain on sale of consolidated affiliates	(40.4)	–		40.4	–
(Income) loss from operations of consolidated affiliates	(31.6)	3.8	(0.2)	28.0	–
Minority interests in earnings of consolidated affiliates	–	–	7.2	–	7.2
Management fees	(20.2)	14.8	5.4	–	–
(Loss) income from continuing operations before income tax (benefit) expense	(20.8)	45.7	12.7	(68.7)	(31.1)
Provision for income tax (benefit) expense	(309.1)	22.2	5.7		(281.2)

Income from continuing operations	288.3		23.5		7.0		(68.7)		250.1	
(Loss) income from discontinued operations, net of income tax expense	(0.7)		(3.1)		0.6		40.7		37.5	
Net income	$	287.6	$	20.4	$	7.6	$	(28.0)	$	287.6

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HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Operations

	Nine Months Ended September 30, 2008				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net operating revenues	$ 67.4	$ 931.5	$ 399.6	$ (19.9)	$ 1,378.6
Operating expenses:					
Salaries and benefits	43.3	465.7	198.8	(6.8)	701.0
Other operating expenses	16.3	133.4	58.7	(6.3)	202.1
General and administrative expenses	78.8	–	–	–	78.8
Supplies	5.9	53.5	21.7	–	81.1
Depreciation and amortization	20.6	33.1	12.1	–	65.8
Impairment of long-lived assets	–	0.6	–	–	0.6
Occupancy costs	3.9	25.9	14.4	(6.6)	37.6
Provision for doubtful accounts	2.0	14.0	4.8	–	20.8
(Gain) loss on disposal of assets	(0.3)	1.2	(0.3)	–	0.6
Government, class action, and related settlements	(29.1)	(0.2)	1.4	–	(27.9)
Professional fees—accounting, tax, and legal	12.9	–	–	–	12.9
Total operating expenses	154.3	727.2	311.6	(19.7)	1,173.4
Loss on early extinguishment of debt	5.8	–	–	–	5.8
Interest expense and amortization of debt discounts and fees	122.6	6.4	3.3	(1.0)	131.3
Other expense (income)	0.5	(0.3)	(3.3)	1.0	(2.1)
Loss on interest rate swap	16.1	–	–	–	16.1
Equity in net income of nonconsolidated affiliates	(2.1)	(5.5)	(0.2)	–	(7.8)
Equity in net income of consolidated affiliates—					