HEALTHSOUTH CORP
Form 10-Q
August 05, 2010

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 June 30, 2010

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 (State or Other Jurisdiction of Incorporation or Organization)	63-0860407 (I.R.S. Employer Identification No.)
3660 Grandview Parkway, Suite 200 Birmingham, Alabama (Address of Principal Executive Offices)	35243 (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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

Large accelerated filer x Accelerated filer ¨ Non-Accelerated filer ¨ Smaller reporting company ¨

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 93,455,973 shares of common stock outstanding, net of treasury shares, as of July 29, 2010.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report contains historical information, as well as forward-looking statements that involve known and unknown risks and relate to future events, our business strategy, our future financial performance, or our projected business results. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “targets,” “potential,” or “continue” or the nega terms or other comparable terminology. Such forward-looking statements are necessarily estimates or forecasts based upon current information and involve a number of risks and uncertainties, many of which are beyond our control. Actual events or results may differ materially from the results anticipated in these forward-looking statements as a result of a variety of factors. Any forward-looking statement is based on information current as of the date of this report and speaks only as of the date on which such statement is made. While it is impossible to identify all such factors, factors that could cause actual results to differ materially from those estimated by us include, but are not limited to, the following:

- each of the factors discussed in Item 1A, Risk Factors, of our Annual Report on Form 10-K for the year ended December 31, 2009, as well as uncertainties and factors discussed elsewhere in this Form 10-Q, in our other filings from time to time with the United States Securities and Exchange Commission, or in materials incorporated therein by reference;
- changes in the regulations of the healthcare industry at either or both of the federal and state levels;
- changes or delays in, or suspension of, reimbursement for our services by governmental or private payors, including our ability to obtain and retain favorable arrangements with third-party payors;
- our ability to attract and retain nurses, therapists, and other healthcare professionals in a highly competitive environment with often severe staffing shortages and the impact on our labor expenses from potential union activity and staffing shortages;
- competitive pressures in the healthcare industry and our response to those pressures;
- our ability to successfully complete and integrate acquisitions, investments, and joint ventures consistent with our growth strategy; and
- general conditions in the economy and capital markets.

The cautionary statements referred to in this section also should be considered in connection with any subsequent written or oral forward-looking statements that may be issued by us or persons acting on our behalf. We undertake no duty to update these forward-looking statements, even though our situation may change in the future. Furthermore, we cannot guarantee future results, events, levels of activity, performance, or achievements.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
	(In Millions, Except Per Share Data)			
Net operating revenues	$496.9	$481.6	$987.9	$954.5
Operating expenses:				
Salaries and benefits	241.6	237.8	483.5	471.1
Other operating expenses	76.6	67.0	143.5	133.9
General and administrative expenses	26.7	24.9	53.0	50.4
Supplies	28.8	28.6	57.1	56.0
Depreciation and amortization	18.7	17.6	37.0	35.0
Occupancy costs	11.4	12.0	23.0	24.0
Provision for doubtful accounts	5.9	9.7	12.8	17.5
Loss on disposal of assets	0.4	1.3	0.4	2.3
Government, class action, and related settlements	-	48.7	-	32.8
Professional fees—accounting, tax, and legal	5.7	(3.3)	8.6	1.5
Total operating expenses	415.8	444.3	818.9	824.5
Loss (gain) on early extinguishment of debt	0.1	(1.3)	0.4	(3.1)
Interest expense and amortization of debt discounts and fees	30.1	31.1	60.6	65.5
Other income	(1.4)	(1.0)	(2.1)	(0.8)
(Gain) loss on interest rate swaps	(0.3)	3.8	4.0	8.8
Equity in net (income) loss of nonconsolidated affiliates	(2.6)	2.7	(5.2)	0.2
Income from continuing operations before income tax (benefit) expense	55.2	2.0	111.3	59.4
Provision for income tax (benefit) expense	(2.2)	(0.3)	0.3	0.9
Income from continuing operations	57.4	2.3	111.0	58.5
Income (loss) from discontinued operations, net of tax	0.1	1.3	(3.0)	(1.4)
Net income	57.5	3.6	108.0	57.1
Less: Net income attributable to noncontrolling interests	(10.2)	(9.1)	(20.0)	(17.7)
Net income (loss) attributable to HealthSouth	47.3	(5.5)	88.0	39.4
Less: Convertible perpetual preferred stock dividends	(6.5)	(6.5)	(13.0)	(13.0)
Net income (loss) attributable to HealthSouth common shareholders	$40.8	$(12.0)	$75.0	$26.4
Weighted average common shares outstanding:				
Basic	92.8	87.6	92.7	87.5
Diluted	108.2	101.5	108.2	101.2
Basic and diluted earnings per common share:				
Income (loss) from continuing operations attributable to HealthSouth common shareholders	$0.44	$(0.15)	$0.84	$0.32
Income (loss) from discontinued operations, net of tax, attributable to HealthSouth common shareholders	0.00	0.01	(0.03)	(0.02)

Net income (loss) attributable to HealthSouth common shareholders	$0.44	$(0.14)	$0.81	$0.30
Amounts attributable to HealthSouth common shareholders:				
Income (loss) from continuing operations	$47.2	$(6.6)	$91.0	$41.3
Income (loss) from discontinued operations, net of tax	0.1	1.1	(3.0)	(1.9)
Net income (loss) attributable to HealthSouth	$47.3	$(5.5)	$88.0	$39.4

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 Balance Sheets
(Unaudited)

	June 30, 2010	December 31, 2009
	(In Millions, Except Share Data)	
Assets		
Current assets:		
Cash and cash equivalents	$ 172.6	$ 80.9
Restricted cash	49.7	67.8
Accounts receivable, net of allowance for doubtful accounts of $32.0 in 2010; $33.1 in 2009	224.8	219.7
Other current assets	56.8	57.6
Total current assets	503.9	426.0
Property and equipment, net	664.5	664.8
Goodwill	423.7	416.4
Intangible assets, net	35.5	37.4
Investments in and advances to nonconsolidated affiliates	31.0	29.3
Other long-term assets	97.5	107.6
Total assets	$ 1,756.1	$ 1,681.5
Liabilities and Shareholders' Deficit		
Current liabilities:		
Current portion of long-term debt	$ 21.5	$ 21.5
Accounts payable	47.3	50.2
Accrued expenses and other current liabilities	322.6	319.5
Total current liabilities	391.4	391.2
Long-term debt, net of current portion	1,633.0	1,641.0
Other long-term liabilities	161.6	159.5
	2,186.0	2,191.7
Commitments and contingencies		
Convertible perpetual preferred stock, $.10 par value; 1,500,000 shares authorized; 400,000 issued; liquidation preference of $1,000 per share	387.4	387.4
Shareholders' deficit:		
HealthSouth shareholders' deficit:		
Common stock, $.01 par value; 200,000,000 shares authorized; issued: 97,624,393 in 2010; 97,238,725 in 2009	1.0	1.0
Capital in excess of par value	2,877.6	2,879.9
Accumulated deficit	(3,629.4)	(3,717.4)
Accumulated other comprehensive loss	(4.0)	-
Treasury stock, at cost (4,166,756 shares in 2010 and 3,957,047 shares in 2009)	(141.5)	(137.5)
Total HealthSouth shareholders' deficit	(896.3)	(974.0)
Noncontrolling interests	79.0	76.4
Total shareholders' deficit	(817.3)	(897.6)

Total liabilities and shareholders’ deficit	$ 1,756.1	$ 1,681.5

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 Comprehensive Income
(Unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
	(In Millions)			
COMPREHENSIVE INCOME				
Net income	$ 57.5	$ 3.6	$ 108.0	$ 57.1
Other comprehensive (loss) income, net of tax:				
Net change in unrealized gain (loss) on available-for-sale securities:				
Unrealized net holding gain arising during the period	-	1.7	0.6	0.1
Reclassifications to net income	-	-	(1.3)	1.6
Net change in unrealized (loss) gain on forward-starting interest rate swaps:				
Unrealized net holding (loss) gain arising during the period	(2.6)	2.7	(4.7)	2.0
Other comprehensive (loss) income before income taxes	(2.6)	4.4	(5.4)	3.7
Provision for income tax benefit related to other comprehensive (loss) income items	1.4	-	1.4	-
Other comprehensive (loss) income, net of tax	(1.2)	4.4	(4.0)	3.7
Comprehensive income	56.3	8.0	104.0	60.8
Comprehensive income attributable to noncontrolling interests	(10.2)	(9.1)	(20.0)	(17.7)
Comprehensive income (loss) attributable to HealthSouth	$ 46.1	$ (1.1)	$ 84.0	$ 43.1

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 Shareholders' Deficit
(Unaudited)

Six Months Ended June 30, 2010
(In Millions)

	HealthSouth Common Shareholders								
	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interests	Total	Comprehensive Income
Balance at beginning of period	93.3	$ 1.0	$ 2,879.9	$ (3,717.4)	$ -	$ (137.5)	$ 76.4	$ (897.6)	
Comprehensive income:									
Net income	-	-	-	88.0	-	-	20.0	108.0	$ 108.0
Other comprehensive loss, net of tax	-	-	-	-	(4.0)	-	-	(4.0)	(4.0)
Comprehensive income									$ 104.0
Forfeiture of restricted stock	(0.1)	-	2.5	-	-	(2.5)	-	-	
Receipt of treasury stock	(0.1)	-	-	-	-	(1.5)	-	(1.5)	
Dividends declared on convertible perpetual preferred stock	-	-	(13.0)	-	-	-	-	(13.0)	
Stock-based compensation	-	-	7.8	-	-	-	-	7.8	
Distributions declared	-	-	-	-	-	-	(17.0)	(17.0)	
Other	0.4	-	0.4	-	-	-	(0.4)	-	
Balance at end of period	93.5	$ 1.0	$ 2,877.6	$ (3,629.4)	$ (4.0)	$ (141.5)	$ 79.0	$ (817.3)	

Six Months Ended June 30, 2009
(In Millions)

	HealthSouth Common Shareholders								
	Number of Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interests	Total	Comprehensive Income
Balance at beginning of period	88.0	$ 1.0	$ 2,956.5	$ (3,812.2)	$ (3.2)	$ (311.5)	$ 82.2	$ (1,087.2)	
Comprehensive income:									
Net income	-	-	-	39.4	-	-	17.7	57.1	$ 57.1
Other comprehensive income, net of tax	-	-	-	-	3.7	-	-	3.7	3.7
Comprehensive income									$ 60.8
Dividends declared on convertible perpetual preferred stock	-	-	(13.0)	-	-	-	-	(13.0)	
Stock-based compensation	-	-	6.6	-	-	-	-	6.6	
Distributions declared	-	-	-	-	-	-	(15.7)	(15.7)	
Other	0.3	-	0.1	-	-	(0.6)	(1.3)	(1.8)	
Balance at end of period	88.3	$ 1.0	$ 2,950.2	$ (3,772.8)	$ 0.5	$ (312.1)	$ 82.9	$ (1,050.3)	

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)

	Six Months Ended June 30, 2010	2009
	(In Millions)	
Cash flows from operating activities:		
Net income	$ 108.0	$ 57.1
Loss from discontinued operations	3.0	1.4
Adjustments to reconcile net income to net cash provided by operating activities—		
Provision for doubtful accounts	12.8	17.5
Provision for government, class action, and related settlements	-	32.8
UBS Settlement proceeds, gross	-	100.0
Depreciation and amortization	37.0	35.0
Loss on interest rate swaps	4.0	8.8
Equity in net (income) loss of nonconsolidated affiliates	(5.2)	0.2
Distributions from nonconsolidated affiliates	3.3	3.9
Stock-based compensation	7.8	6.6
Deferred tax provision	2.1	1.9
Other	2.7	3.1
(Increase) decrease in assets—		
Accounts receivable	(17.9)	(25.8)
Other assets	(5.8)	(0.7)
Income tax refund receivable	4.3	45.4
(Decrease) increase in liabilities—		
Accounts payable	(2.8)	2.2
Accrued fees and expenses for derivative plaintiffs' attorneys in UBS Settlement	-	(26.2)
Other liabilities	24.4	(18.3)
Government, class action, and related settlements	(0.8)	(8.7)
Net cash used in operating activities of discontinued operations	(4.2)	(7.0)
Total adjustments	61.7	170.7
Net cash provided by operating activities	172.7	229.2

(Continued)

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HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Continued)
(Unaudited)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
	(In Millions)	
Cash flows from investing activities:		
Capital expenditures	(29.9)	(34.4)
Acquisition of a business, net of cash acquired	(9.9)	-
Proceeds from sale of restricted investments	10.0	1.6
Purchase of restricted investments	(13.3)	(1.6)
Net change in restricted cash	18.1	(15.7)
Net settlements on interest rate swaps	(23.1)	(19.1)
Net investment in interest rate swap	-	(6.4)
Other	(0.1)	(0.8)
Net cash provided by (used in) investing activities of discontinued operations	8.5	(1.4)
Net cash used in investing activities	(39.7)	(77.8)
Cash flows from financing activities:		
Principal payments on debt, including pre-payments	(3.8)	(60.9)
Borrowings on revolving credit facility	-	10.0
Payments on revolving credit facility	-	(50.0)
Principal payments under capital lease obligations	(7.2)	(6.6)
Dividends paid on convertible perpetual preferred stock	(13.0)	(13.0)
Distributions paid to noncontrolling interests of consolidated affiliates	(18.3)	(15.8)
Other	0.9	0.7
Net cash provided by financing activities of discontinued operations	-	1.8
Net cash used in financing activities	(41.4)	(133.8)
Increase in cash and cash equivalents	91.6	17.6
Cash and cash equivalents at beginning of period	80.9	32.1
Cash and cash equivalents of facilities held for sale at beginning of period	0.1	0.1
Less: Cash and cash equivalents of facilities held for sale at end of period	-	-
Cash and cash equivalents at end of period	$172.6	$49.8

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 rehabilitative healthcare 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 in HealthSouth's Annual Report on Form 10-K filed on February 23, 2010 (the "2009 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 have been omitted in these interim statements, as allowed by such SEC rules and regulations. The condensed consolidated balance sheet as of December 31, 2009 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.

Business Combinations—

On June 1, 2010, we completed the acquisition of Desert Canyon Rehabilitation Hospital, a 50-bed inpatient rehabilitation hospital located in southwest Las Vegas, Nevada. We accounted for this acquisition under the purchase method of accounting and reported the results of operations of the acquired hospital from the date of acquisition. As a result of this transaction, Goodwill increased by $7.3 million. We have not prepared pro forma financial information as the results of operations of this acquired business and its assets are not material on a consolidated basis.

Long-term Debt—

As discussed in Note 8, Long-term Debt, to the consolidated financial statements accompanying the 2009 Form 10-K, our credit agreement includes a $100 million synthetic letter of credit facility. During the six months ended June 30, 2010, we permanently reduced this facility by $40 million to $60 million. As of June 30, 2010, $52.9 million were utilized under the synthetic letter of credit facility. These letters are being used in the ordinary course of business primarily to secure workers' compensation and other insurance coverages.

Stock-Based Compensation—

In February 2010, we granted 0.9 million of restricted stock awards to members of our management team and our board of directors. Approximately 0.1 million of the awards granted are restricted stock units that vest upon grant. The remaining awards are shares of restricted stock that contain a service and either a performance or market condition. For these awards, the number of shares that will ultimately be issued to employees may vary based on the Company's performance during the applicable performance measurement period. Additionally, we granted 0.2 million stock options to members of our management team. The fair value of these awards and options were determined using the policies described in the 2009 Form 10-K.

Out-of-Period Adjustments—

During the preparation of our condensed consolidated financial statements for the quarterly period ended June 30, 2009, we identified an error in our consolidated financial statements as of and for the year ended December 31, 2008 and prior periods and our condensed consolidated financial statements as of and for the quarterly period ended March 31, 2009. We corrected this error in our financial statements by adjusting Equity in net (income) loss of nonconsolidated affiliates, which resulted in an understatement of both our Income from continuing operations before income tax (benefit) expense and our Net income of approximately $4.9 million and $4.5 million for the three and six months ended June 30, 2009, respectively. This error related primarily to an approximate $9.6 million overstatement of our investment in a joint venture hospital we account for using the equity method of accounting due to the understatement of prior period income tax provisions of this joint venture hospital and the adjustment of certain liabilities due to this joint venture hospital. We also adjusted Accrued expenses and other current liabilities by approximately $4.7 million due to changes in amounts due to us for expenses paid on behalf of this joint venture hospital. We do not believe these adjustments are material to the condensed consolidated financial statements as of December 31, 2009 and for the three and six months ended June 30, 2009 or to any prior years' consolidated financial statements. As a result, we have not restated any prior period amounts.

Recent Accounting Pronouncements—

Since the filing of the 2009 Form 10-K, we do not believe any 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. Investments in and Advances to Nonconsolidated Affiliates:

Investments in and advances to nonconsolidated affiliates as of June 30, 2010 represents our investment in 16 partially owned subsidiaries, of which 11 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 approximately 1% 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 June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net operating revenues	$20.2	$18.1	$40.3	$35.5
Operating expenses	(13.1)	(11.7)	(26.0)	(23.4)
Income from continuing operations, net of tax	5.5	5.3	11.8	10.3
Net income	5.5	5.3	11.8	10.3

3. Derivative Instruments

Interest Rate Swaps Not Designated as Hedging Instruments—

In March 2006, we entered into an interest rate swap to effectively convert the floating rate of a portion of our credit agreement to a fixed rate in order to limit the variability of interest-related payments caused by changes in LIBOR. Under this interest rate swap agreement, we pay a fixed rate of 5.2% on a notional principal of $984.0 million, while the counterparties to this agreement pay a floating rate based on 3-month LIBOR, which was 0.5% at June 10, 2010, which was the most recent interest rate set date. The termination date of this swap is March 10, 2011. The fair market value of this swap as of June 30, 2010 and December 31, 2009 was ($33.5) million and ($54.8) million, respectively, and is included in Accrued expenses and other current liabilities in our condensed consolidated balance sheets.

In June 2009, we entered into a receive-fixed swap as a mirror offset to $100.0 million of the $984.0 million interest rate swap discussed above in order to reduce our effective fixed rate to total debt ratio. Under this interest rate swap agreement, we pay a variable rate based on 3-month LIBOR, while the counterparty to this agreement pays a fixed rate of 5.2% on a notional principal of $100.0 million. Net settlements commenced in September 2009 and are made quarterly on the same settlement schedule as the $984.0 million interest rate swap discussed above. The termination date of this swap is March 10, 2011. Our initial net investment in this swap was

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$6.4 million. The fair market value of this swap as of June 30, 2010 was $3.4 million and is included in Other current assets in our condensed consolidated balance sheet. The fair market value of this swap as of December 31, 2009 was $5.6 million. Of this amount, $4.7 million is included in Other current assets with the remainder included in Other long-term assets in our condensed consolidated balance sheet.

These interest rate swaps are not designated as hedges. Therefore, changes in the fair value of these interest rate swaps are included in current-period earnings as (Gain) loss on interest rate swaps.

During the three and six months ended June 30, 2010, we made net cash settlement payments of $11.2 million and $23.1 million, respectively, to our counterparties. During the three and six months ended June 30, 2009, we made net cash settlement payments of $10.6 million and $19.1 million, respectively, to our counterparties. Net settlement payments or receipts on these swaps are included in the line item (Gain) loss on interest rate swaps in our condensed consolidated statements of operations.

Forward-Starting Interest Rate Swaps Designated as Cash Flow Hedges—

In December 2008, we entered into a $100 million forward-starting interest rate swap as a cash flow hedge of future interest payments on our term loan facility. Under this swap agreement, we will pay a fixed rate of 2.6% while the counterparty will pay a floating rate based on 3-month LIBOR. Net settlements will commence on June 10, 2011. The termination date of this swap is December 12, 2012. The fair market value of this swap as of June 30, 2010 and December 31, 2009 was ($2.2) million and $0.4 million, respectively, and is included in Accrued expenses and other current liabilities and Other long-term assets, respectively, in our condensed consolidated balance sheets.

In March 2009, we entered into an additional $100 million forward-starting interest rate swap as a cash flow hedge of future interest payments on our term loan facility. Under this swap agreement, we will pay a fixed rate of 2.9% while the counterparty will pay a floating rate based on 3-month LIBOR. Net settlements will commence on June 10, 2011. The termination date of this swap is September 12, 2012. The fair market value of this swap as of June 30, 2010 and December 31, 2009 was ($2.5) million and ($0.3) million, respectively, and is included in Accrued expenses and other current liabilities in our condensed consolidated balance sheets.

Both forward-starting swaps are designated as cash flow hedges and are accounted for under the policies described in Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements accompanying the 2009 Form 10-K. The effective portion of changes in the fair value of these cash flow hedges is deferred as a component of other comprehensive income and is reclassified into earnings as part of interest expense in the same period in which the forecasted transaction impacts earnings.

See Note 9, Derivative Instruments, to the consolidated financial statements accompanying the 2009 Form 10-K for additional information related to these interest rate swaps. See also Note 5, Fair Value Measurements.

4. 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. 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 June 30, 2010, we were secondarily liable for 58 such guarantees. The remaining terms of these guarantees ranged from one month to 108 months. If we were required to perform under all such guarantees, the maximum amount we would be required to pay approximated $42.7 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

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HealthSouth Corporation and Subsidiaries
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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 June 30, 2010, we have been notified by one lessor regarding our former diagnostic division's failure to perform under one equipment lease. As a result, we have recorded a charge of $0.6 million as part of discontinued operations and excluded this guarantee from the above amounts.

5. Fair Value Measurements:

Our financial assets and liabilities that are measured at fair value on a recurring basis are as follows (in millions):

		Fair Value Measurements at Reporting Date Using			
June 30, 2010	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)
Other current assets:					
Restricted marketable securities	$ 1.0	$ -	$ 1.0	$ -	M
June 2009 trading swap	3.4	-	3.4	-	I
Other long-term assets:					
Restricted marketable securities	24.0	-	24.0	-	M
Accrued expenses and other current liabilities:					
March 2006 trading swap	(33.5)	-	(33.5)	-	I
December 2008 forward-starting swap	(2.2)	-	(2.2)	-	I
March 2009 forward-starting swap	(2.5)	-	(2.5)	-	I
December 31, 2009					
Other current assets:					
Restricted marketable securities	$ 2.7	$ 1.8	$ 0.9	$ -	M
June 2009 trading swap	4.7	-	4.7	-	I
Other long-term assets:					
Restricted marketable securities	18.3	-	18.3	-	M
December 2008 forward-starting swap	0.4	-	0.4	-	I
June 2009 trading swap	0.9	-	0.9	-	I
Accrued expenses and other current liabilities:					
March 2006 trading swap	(54.8)	-	(54.8)	-	I
March 2009 forward-starting swap	(0.3)	-	(0.3)	-	I

(1) The three valuation techniques are: market approach (M), cost approach (C), and income approach (I).

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In addition to assets and liabilities recorded at fair value on a recurring basis, we are also required to record assets and liabilities at fair value on a nonrecurring basis. Generally, assets are recorded at fair value on a nonrecurring basis as a result of impairment charges or similar adjustments made to the carrying value of the applicable assets. Assets measured at fair value on a nonrecurring basis are as follows (in millions):

		Fair Value Measurements at Reporting Date Using			Total Losses	
	Net Carrying Value as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
Other long-term assets:						
Assets held for sale	$14.2	$-	$14.2	$ -	$(0.5)	$(0.5)

During the three and six months ended June 30, 2010, we did not record any gains or losses related to our nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis as part of our continuing operations. During the first quarter of 2010, we recorded impairment charges of $0.6 million as part of our results of discontinued operations. This charge related to a hospital that was closed in 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.

The above losses incurred in 2009 represented our write-down of certain assets held for sale to their estimated fair value based on offers we received from third parties to acquire the assets. These losses are included in Loss on disposal of assets in our condensed consolidated statements of operations for the three and six months ended June 30, 2009.

The carrying value equals fair value for our financial instruments that are not included in the table below and are classified as current in our condensed consolidated balance sheets. The carrying amounts and estimated fair values for all of our other financial instruments are presented in the following table (in millions):

	As of June 30, 2010		As of December 31, 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Interest rate swap agreements:				
March 2006 trading swap	$(33.5)	$(33.5)	$(54.8)	$(54.8)
December 2008 forward-starting swap	(2.2)	(2.2)	0.4	0.4
March 2009 forward-starting swap	(2.5)	(2.5)	(0.3)	(0.3)
June 2009 trading swap	3.4	3.4	5.6	5.6
Long-term debt:				
Term Loan Facility	747.5	725.7	751.3	714.5
10.75% Senior Notes due 2016	495.2	540.0	494.9	542.5

8.125% Senior Notes due 2020	285.3	285.3	285.2	284.7
Other bonds payable	1.8	1.8	1.8	1.8
Other notes payable	28.0	28.0	28.0	28.0
Financial commitments:				
Letters of credit	-	52.9	-	95.2

6. Income Taxes:

Our Provision for income tax benefit of $2.2 million for the three months ended June 30, 2010 includes the following: (1) current income tax expense of $3.0 million primarily attributable to state income tax expense of subsidiaries which have separate state filing requirements, alternative minimum tax (“AMT”) expense, and federal income taxes for subsidiaries not included in our federal consolidated income tax return; (2) current income tax benefit of $6.9 million primarily attributable to a reduction in unrecognized tax benefits due to settlements with state taxing authorities and the lapse of the applicable statute of limitations for certain claims; and (3) deferred income tax expense of $1.7 million primarily attributable to adjustments for income taxes related to the reversal of previously established other comprehensive income items and increases in basis differences of certain indefinite-lived assets.

Our Provision for income tax expense of $0.3 million for the six months ended June 30, 2010 includes the following: (1) current income tax expense of $6.0 million primarily attributable to state income tax expense of subsidiaries which have separate state filing requirements, a reduction in the amount of state income tax refunds previously accrued, AMT expense, and federal income taxes for subsidiaries not included in our federal consolidated income tax return; (2) current income tax benefit of $7.8 million primarily attributable to a reduction in unrecognized tax benefits due to settlements with state taxing authorities and the lapse of the applicable statute of limitations for certain claims; and (3) deferred income tax expense of $2.1 million primarily attributable to adjustments for income taxes related to the reversal of previously established other comprehensive income items and increases in basis differences of certain indefinite-lived assets.

We have significant federal and state net operating loss carryforwards (“NOLs”) that expire in various amounts at varying times through 2029. We maintain a valuation allowance against our net deferred tax assets, including substantially all of these NOLs. No valuation allowance has been provided on deferred tax assets attributable to subsidiaries not included within the federal consolidated group.

On a quarterly basis, we assess the likelihood of realization of our deferred tax assets considering all available evidence, both positive and negative. Our most recent operating performance, the scheduled reversal of temporary differences, our forecast of taxable income in future periods, and the availability of prudent tax planning strategies are important considerations in our assessment. At this time, management continues to believe it is more-likely-than-not we will not realize a portion of our deferred tax assets. Adjustments to the valuation allowance may be made in future periods if there is a change in management’s assessment of the amount of deferred income tax assets that is realizable. As of June 30, 2010, our valuation allowance approximated $888 million.

Our utilization of NOLs could be subject to the Internal Revenue Code Section 382 (“Section 382”) limitation and may be limited in the event of certain cumulative changes in ownership interests of significant shareholders over a three-year period in excess of 50%. Section 382 imposes an annual limitation on the use of these losses to an amount equal to the value of a company at the time of an ownership change multiplied by the long-term tax exempt rate. At this time, we do not believe the Section 382 limitation will restrict our ability to use any NOLs before they expire. However, no such assurances can be provided.

Our Provision for income tax benefit of $0.3 million for the three months ended June 30, 2009 includes the following: (1) net current income tax benefit of $0.7 million primarily attributable to state income tax refunds received, or expected to be received, and (2) deferred income tax expense of $0.4 million attributable to increases in basis differences of certain indefinite-lived assets. Our Provision for income tax expense of $0.9 million for the six months ended June 30, 2009 includes the following: (1) net current income tax benefit of $1.0 million primarily attributable to state income tax refunds received, or expected to be received, and (2) deferred income tax expense of $1.9 million attributable to increases in basis differences of certain indefinite-lived assets and a decrease in our deferred tax asset related to the AMT Refundable Tax Credit.

Total remaining gross unrecognized tax benefits were $50.9 million as of December 31, 2009, all of which would affect our effective tax rate if recognized. Total accrued interest expense related to unrecognized tax benefits as of December 31, 2009 was $1.9 million. Gross unrecognized tax benefits decreased during the three and six months ended June 30, 2010 due primarily to settlements with state taxing authorities and the lapse of the applicable statute of limitations for certain claims. Total remaining gross unrecognized tax benefits were $45.4 million as of June 30, 2010, all of which would affect our effective tax rate if recognized. Total accrued interest expense related to unrecognized tax benefits as of June 30, 2010 was $1.0 million.

Our continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. For the three and six months ended June 30, 2010, we recorded $1.7 million and $1.8 million, respectively, of net interest income as part of our income tax provision. For the three and six months ended June 30, 2009, we recorded $1.3 million and $1.4 million, respectively, of net interest income as part of our income tax provision. Total accrued interest income was $0.2 million and $0.3 million as of June 30, 2010 and December 31, 2009, 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 have settled federal income tax examinations with the IRS for all tax years through 2006. In the first quarter of 2010, the IRS initiated an audit of the 2008 tax year by combining it with an ongoing audit of the 2007 tax year.

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For the tax years that remain open under the applicable statutes of limitations, amounts related to 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 state income tax refund claims. The process of resolving these tax matters with the applicable taxing authorities will continue in 2010. 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.

7. 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 June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Numerator:				
Income from continuing operations	$ 57.4	$ 2.3	$ 111.0	$ 58.5
Less: Net income attributable to noncontrolling interests included in continuing operations	(10.2)	(8.9)	(20.0)	(17.2)
Less: Convertible perpetual preferred stock dividends	(6.5)	(6.5)	(13.0)	(13.0)
Income (loss) from continuing operations attributable to HealthSouth common shareholders	40.7	(13.1)	78.0	28.3
Income (loss) from discontinued operations, net of tax, attributable to HealthSouth common shareholders	0.1	1.1	(3.0)	(1.9)
Net income (loss) attributable to HealthSouth common shareholders	$ 40.8	$ (12.0)	$ 75.0	$ 26.4
Denominator:				
Basic weighted average common shares outstanding	92.8	87.6	92.7	87.5
Diluted weighted average common shares outstanding	108.2	101.5	108.2	101.2
Basic and diluted earnings per common share:				

Income (loss) from continuing operations attributable to HealthSouth common shareholders	$ 0.44	$ (0.15)	$ 0.84	$ 0.32
Income (loss) from discontinued operations, net of tax, attributable to HealthSouth common shareholders	0.00	0.01	(0.03)	(0.02)
Net income (loss) attributable to HealthSouth common shareholders	$ 0.44	$ (0.14)	$ 0.81	$ 0.30

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 June 30, 2010 and 2009, the number of potential shares approximated 15.4 million and 13.9 million, respectively. For the six months ended June 30, 2010 and 2009, the number of potential shares approximated 15.5 million and 13.7 million, respectively. For the three and six months ended June 30, 2010 and 2009, approximately 13.1 million of the potential shares related to our Convertible perpetual preferred stock. For the three months ended June 30, 2010, basic and diluted earnings per common share amounts are the same due to rounding. For the three months ended June 30, 2009, including these potential common shares in the denominator resulted in an antidilutive per share amount due to our Loss from continuing operations attributable to HealthSouth common shareholders. For the six months ended June 30, 2010 and 2009, adding back the dividends for the Convertible perpetual preferred stock to our Income from continuing operations attributable to HealthSouth common shareholders causes a per share increase when calculating diluted earnings per common share resulting in an antidilutive per share amount. Therefore, basic and diluted earnings per common share amounts are the same for all periods presented.

Options to purchase 2.0 million shares and 2.6 million shares of common stock were outstanding as of June 30, 2010 and 2009, respectively, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

See Note 11, Convertible Perpetual Preferred Stock, and Note 20, Earnings per Common Share, to the consolidated financial statements accompanying the 2009 Form 10-K for additional information related to common stock, common stock warrants, and convertible perpetual preferred stock.

8. Contingencies:

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 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 22, Settlements, "Securities Litigation Settlement," to the consolidated financial statements accompanying the 2009 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 22, Settlements, "Securities Litigation Settlement," to the consolidated financial statements accompanying the 2009 Form 10-K, 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 was consolidated on the same docket with the Consolidated Securities Action. The plaintiff in this case has neither opted out of nor filed a timely claim in the Consolidated Securities Action settlement discussed in Note 22, Settlements, "Securities Litigation Settlement," to the consolidated financial statements accompanying the 2009 Form 10-K. Although the deadline for opting out in the Consolidated Securities Action has passed, if the plaintiff attempts to resume the Burke action, we will continue to vigorously defend ourselves. However, based on the stage of litigation and lack of action on the part of the plaintiff, we are unable to determine whether this case will continue or, if it does, 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 and filed August 28, 2002. Derivative lawsuits in other jurisdictions have been stayed. The Tucker complaint named as defendants a number of our former officers and directors. Tucker also asserted claims on our behalf against Ernst & Young LLP, our former auditor, and various UBS entities who formerly served as our investment bankers, as well as against MedCenterDirect.com, Capstone Capital Corporation, now known as HR Acquisition I Corp., and G.G. Enterprises. 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 January 13, 2009, the Circuit Court of Jefferson County, Alabama approved the agreement among us, the derivative plaintiffs, and UBS Securities to settle the claims against and by UBS Securities in the Tucker litigation. On May 8, 2009, the Circuit Court of Jefferson County, Alabama approved the agreement among us, the derivative plaintiffs, and Capstone to settle the claims against Capstone in the Tucker litigation. On June 18, 2009, the court found Mr. Scrushy liable for, and awarded us, $2.9 billion in damages as a result of breaches of fiduciary duty and fraud he perpetrated from 1996 to 2003. On July 24, 2009, Mr. Scrushy filed a notice of appeal of the trial court's decision. No assurances can be given as to whether or when any amounts will be received from Mr. Scrushy, nor can we provide any assurances as to the collectability of any amounts owed from Mr. Scrushy. Therefore, no amounts related to this award are included in our condensed consolidated financial statements. The Tucker derivative litigation and the related settlements to date are more fully described in Note 22, Settlements, to the consolidated financial statements accompanying the 2009 Form 10-K.

The settlements with UBS Securities and Capstone do not release our claims against any other defendants in the Tucker litigation, or against our former independent auditor, Ernst & Young, which remain pending in arbitration. The Tucker derivative claims against Ernst & Young and other defendants listed above remain pending and have moved through fact discovery on an expedited schedule that was coordinated with the federal securities claims by our former stockholders and bondholders against Mr. Scrushy, Ernst & Young, and UBS. We are no longer a party in the federal securities claims action described in Note 22, Settlements, "Securities Litigation Settlement," to the consolidated financial statements accompanying the 2009 Form 10-K by our former stockholders and bondholders against Mr. Scrushy, Ernst & Young, and UBS and are not a party to or beneficiary of any settlements between the plaintiffs and the remaining defendants.

Litigation By and Against Richard M. Scrushy—

On December 9, 2005, Mr. Scrushy filed a complaint in the Circuit Court of Jefferson County, Alabama, captioned Scrushy v. HealthSouth. 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, we counterclaimed against Mr. Scrushy, asserting claims for breaches of fiduciary duty and fraud arising out of Mr. Scrushy's tenure with us, and seeking compensatory damages, punitive damages, and disgorgement of wrongfully obtained benefits. We also asserted that any employment agreements with Mr. Scrushy should be void and unenforceable. On July 7, 2009, we filed a motion for summary judgment on all claims by Mr. Scrushy based upon the Tucker court's June 18, 2009 ruling that Mr. Scrushy's employment agreements are void and rescinded. We understand that the court does not intend to rule on this motion at the present time.

On June 18, 2009, the Circuit Court of Jefferson County, Alabama ruled on our derivative claims against Mr. Scrushy presented during a non-jury trial held May 11 to May 26, 2009. The court held Mr. Scrushy responsible for fraud and breach of fiduciary duties and awarded us $2.9 billion in damages. On July 24, 2009, Mr. Scrushy filed a notice of appeal of the trial court's decision, and the parties have submitted their briefs to the Supreme Court of Alabama, which has not indicated the timing of a hearing, if any, or decision. At this time, we cannot predict when and to what extent this judgment can be collected. We will pursue collection aggressively and to the fullest extent permitted by law. We, in coordination with derivative plaintiffs' counsel, are attempting to locate, in order to collect the judgment, Mr. Scrushy's current assets and other assets we believe were improperly disposed. Part of this effort is a fraudulent transfer complaint filed on July 2, 2009 against Mr. Scrushy and a number of related entities by derivative plaintiffs for the benefit of HealthSouth in the Circuit Court of Jefferson County, Alabama, captioned Tucker v. Scrushy. In that same case, on August 26, 2009, Mr. Scrushy's wife, Leslie Scrushy, filed a counterclaim against the plaintiffs and HealthSouth seeking a declaration that certain personal property belongs to her or her children and not to Mr. Scrushy. HealthSouth filed an answer in this case on September 24, 2009, denying Mrs. Scrushy's entitlement to the relief she seeks. While these proceedings continue, some of Mr. Scrushy's assets have been seized and sold at auction pursuant to the state law procedure for collection of a judgment. Other assets will likewise be sold from time to time. We do not anticipate that any material amount of his assets, or the proceeds from their sale, will be distributed to us or any other party until the final disposition of Mr. Scrushy's appeal of the verdict. We are obligated to pay 35% of any recovery from Mr. Scrushy along with reasonable out-of-pocket expenses to the attorneys for the derivative shareholder plaintiffs. Under the Consolidated Securities Action settlement, we must also pay the federal plaintiffs 25% of any net recovery from Mr. Scrushy. After payment of these obligations and other amounts related to professional fees and expenses, we expect our recovery to be between 40% and 45% of any amounts collected.

In March 2009, Mr. Scrushy filed an arbitration demand claiming we are obligated under a separate indemnification agreement to indemnify him for certain costs associated with litigation and to advance to him his attorneys' fees and costs. On May 14, 2009, the arbitrator ruled we should deposit certain funds for attorneys' fees in escrow until after a ruling in the Tucker litigation. As a result of the Tucker court's June 18, 2009 ruling that Mr. Scrushy committed fraud and breached his fiduciary duties, the arbitrator allowed us to withdraw all funds from the escrow. Any future obligation to pay such fees would be tied to the success of his appeal of the June 18, 2009 ruling.

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Litigation By and Against 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 certain 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. 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, expenses, 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 our counterclaims to arbitration pursuant to a clause in the engagement agreements between HealthSouth and Ernst & Young. On July 12, 2006, we and the derivative plaintiffs 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, we and the derivative plaintiffs 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. The three-person arbitration panel that will adjudicate the claims and counterclaims in arbitration has been selected under rules of the American Arbitration Association (the "AAA"). The arbitration process has begun. However, pursuant to an order of the AAA panel, all aspects of the arbitration are confidential. Accordingly, we will not discuss the arbitration until there is a resolution. Based on the stage of litigation and review of the current facts and circumstances, it is not possible to estimate the amount of loss, if any, or range of possible loss that might result from an adverse judgment or a settlement of this case.

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 generally 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. 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, 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 (the “Alabama Action”).

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 directorservices 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. We acquired Horizon/CMS in 1997 and sold it to Meadowbrook Healthcare, Inc. 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. We were not a party to the 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 us.

The complaint filed by General Medicine against us in the Alabama Action alleged that while Horizon/CMS was our wholly owned subsidiary 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 we 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 we, while 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.

In the Alabama Action, 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 Alabama Action has now entered the discovery stage but is stayed subject to the outcome of the pending motions in the Michigan Action discussed below. We intend to vigorously defend ourselves against General Medicine's claim and to vigorously prosecute our counterclaims against General Medicine.

In the Michigan Action, we filed a motion on October 17, 2008 asking the court to set aside the Consent Judgment on grounds that it was the product of fraud on the court and collusion by the parties. On May 21, 2009, the court granted our motion to set aside the Consent Judgment on grounds that it was the product of fraud on the court. In its order setting aside the Consent Judgment, the court directed General Medicine and Horizon/CMS to confer with each other and the court's case manager to determine what further proceedings are appropriate in the Michigan Action. On June 17, 2009, Horizon/CMS filed a motion for clarification requesting the court rule that Horizon/CMS has fully complied with its obligations under the settlement agreement and is therefore not required to participate in any further proceedings. On July 21, 2009, General Medicine filed a motion to compel Horizon/CMS to enter into a new consent judgment in favor of General Medicine. On February 25, 2010, the court granted Horizon/CMS's motion, denied General Medicine's motion, and ruled that no further proceedings were necessary in the litigation. On March 9, 2010, General Medicine filed an appeal of the court's decision to the Sixth Circuit Court of Appeals. On March 25, 2010, we moved to intervene in General Medicine's appeal, and on March 26, 2010, we moved to dismiss a portion of General Medicine's appeal as untimely. On July 9, 2010, the Court of Appeals granted our motion to intervene but denied our motion to dismiss "at this time" on grounds that our argument is "inextricably intertwined" with the merits of General Medicine's appeal. Accordingly, we intend to reassert this argument in our principal brief which will be due on September 21, 2010.

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.

United HealthCare Services Litigation—

On March 19, 2009, United HealthCare Services, Inc. and certain affiliates filed an initial arbitration demand with the AAA against us relating to disputes over therapy service claims paid from 1997 through 2003. United alleges that during that period we submitted fraudulent claims, or claims otherwise in breach of various provider agreements, for reimbursement of therapy services for patients insured under plans provided or administered by United. United initially requested an accounting and seeks compensatory damages in excess of $10 million, punitive damages, interest, and attorneys' fees.

On April 14, 2009, we filed an action in Circuit Court in Jefferson County, Alabama, captioned HealthSouth Corp. v. United Healthcare Services, Inc., seeking a declaratory judgment that we are not required to arbitrate the claims alleged in United's arbitration demand, seeking an order enjoining the AAA arbitration, and reserving our claims against United for underpayment and breach of contract. We asserted that the AAA lacks jurisdiction to arbitrate these claims because we did not agree to arbitration and because, among other reasons, United's arbitration demand disregards the conditions precedent to arbitration and other terms contained in the provider agreements upon which United relies, seeks damages expressly excluded from arbitration, and violates state insurance laws which prohibit United from seeking to recoup claims many years after they were submitted and paid. On May 18, 2009, United filed a motion with the court to compel arbitration of the claims presented in their AAA arbitration demand. The court granted United's motion and dismissed our complaint on March 3, 2010. The court ruled that the arbitration agreements were valid and that the parties should submit their disputes under those agreements to the AAA arbitration process.

On May 1, 2009, we filed with the AAA arbitration panel our answer requesting that the arbitration be stayed pending the outcome of our action filed in Circuit Court in Jefferson County, challenging, as a preliminary matter, the AAA's jurisdiction to arbitrate the claims alleged by United, denying the claims asserted by United, raising defenses and asserting counterclaims including breaches of contract, breach of implied covenant of good faith and fair dealing. In connection with our counterclaim, we are seeking restitution for, among other things, United's wrongful recoupment and underpayment of paid claims submitted and compensatory damages in excess of $10 million, together with interest and the costs, fees and expenses of arbitration.

On May 16, 2009, United filed with the AAA panel an amended arbitration demand adding certain Select Medical Corporation subsidiaries as named respondents, which, with one exception, are successors to HealthSouth entities that signed one or more of the provider agreements at issue in United's demand. Pursuant to the Stock Purchase Agreement between us and Select, we are obligated to defend and indemnify Select and its affiliates named in United's amended arbitration demand. See Note 18, Assets Held for Sale and Results of Discontinued Operations, and the "Other Matters" section of Note 23, Contingencies and Other Commitments, to the consolidated financial statements accompanying the 2009 Form 10-K. On June 11, 2009, answers were filed with the AAA panel on behalf of all HealthSouth and Select respondents. These answers reiterated the denials, defenses, jurisdictional objections and challenges, and counterclaims previously asserted in our initial answer. The Select entities did not assert any counterclaims. On March 10, 2010, the AAA panel directed United to file separate demands with respect to each separate provider agreement at issue. On April 7, 2010, United filed 18 separate amended demands, each alleging between $0.5 million and $1.0 million in damages under various different provider agreements for a combined total of $13.0 million in damages alleged. United, however, dropped all claims for punitive damages against us that were previously sought in the initial arbitration demands. On May 14, 2010, we filed our answers, objections, and counterclaims to United's amended demands. In response to our filing, the AAA panel determined that five of United's amended demands were deficient on their face and could not be arbitrated by the AAA panel. Accordingly, there are now 13 separate amended arbitration demands under various different provider agreements seeking a combined total of $9.5 million in damages. On June 21, 2010, United filed its answers generally denying our counterclaims asserted in each of the amended arbitration demands. Each amended demand will be arbitrated separately before an AAA panel in the jurisdiction specified in the related provider agreement. We will continue to contest AAA's jurisdiction over all of United's claims before arbitrating the merits of United's disputes.

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HealthSouth Corporation and Subsidiaries
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We intend to vigorously defend ourselves in each of the arbitration hearings and prosecute our counterclaims against United. Although we continue to believe in the merit of our claims and counterclaims and the lack of merit in United's, we have recorded an estimate of this potential liability as of June 30, 2010 and December 31, 2009, as this claim relates primarily to our former outpatient division. We consider this estimate to be adequate for these liability risks. However, there can be no assurance the ultimate liability, if any, will not exceed our estimate.

Other Litigation—

We have been named as a defendant in a lawsuit filed March 28, 2003 by individuals in the Circuit Court of Jefferson County, Alabama, captioned Nichols v. HealthSouth Corp. 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. This case was consolidated with the Tucker case for discovery and other pretrial purposes. The plaintiffs are subject to the Consolidated Securities Action settlement discussed in Note 22, Settlements, "Securities Litigation Settlement," to the consolidated financial statements accompanying the 2009 Form 10-K, and thereby foreclosed from pursuing these state court actions based on purchases made during the class period unless they opted out of that settlement. 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. Mr. Kapoor has not challenged this determination. The remaining Nichols plaintiffs that opted out of the settlement claimed losses of approximately $5.4 million. The Nichols lawsuit is currently stayed in the Circuit Court. On January 12, 2009, the plaintiffs in the case filed a motion to lift the stay which the court subsequently denied. 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, if any, or range of possible loss that might result from an adverse judgment or a settlement of these cases.

We were named as a defendant in a lawsuit filed March 3, 2009 by an individual in the Court of Common Pleas, Richland County, South Carolina, captioned Sulton v. HealthSouth Corp, et al. The plaintiff alleged that certain treatment he received at a HealthSouth facility complicated a pre-existing infectious injury. The plaintiff sought recovery for pain and suffering, medical expenses, punitive damages, and other damages. On July 30, 2010, the jury in this case returned a verdict in favor of the plaintiff for $12.3 million in damages. We intend to appeal this verdict and vigorously defend ourselves in this case. We believe the attending nurses acted both responsibly and professionally, and we will continue to support and defend them. Although we continue to believe in the merit of our defenses and counterarguments, we have recorded a liability of $12.3 million in Accrued expenses and other liabilities in our condensed consolidated balance sheet as of June 30, 2010 with a corresponding receivable of $7.7 million in Other current assets for the portion of the claim we expect to be covered through our excess insurance coverages, resulting in a net charge of $4.6 million to Other operating expenses in our condensed consolidated statements of operations for the three and six months ended June 30, 2010. The $4.6 million portion of this claim would be a covered claim through our captive insurance subsidiary, HCS, Ltd.

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 Office of Inspector General of the United States Department of Health and Human Services 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, HealthSouth refunding amounts to Medicare or other federal healthcare programs. See Note 22, Settlements, “Medicare Program Settlement - The 2004 Civil DOJ Settlement” and “Medicare Program Settlement - The December 2004 Corporate Integrity Agreement” to the consolidated financial statements accompanying the 2009 Form 10-K.

We are undergoing an audit of unclaimed property which is being conducted by Kelmar Associates, LLC for three states for the years 1996 through 2005. We do not have sufficient information from the auditors to date to estimate any obligation that may result from this audit.

We also face certain financial risks and challenges relating to our 2007 divestiture transactions (see Note 18, Assets Held for Sale and Results of Discontinued Operations, to the consolidated financial statements accompanying the 2009 Form 10-K) following their closing. These include indemnification obligations, which in the aggregate could have a material adverse effect on our financial position, results of operations, and cash flows.

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9. 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 the 2009 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 11, Convertible Perpetual Preferred Stock, to the consolidated financial statements accompanying the 2009 Form 10-K, our preferred stock generally provides for the payment of cash dividends, subject to certain limitations.

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HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Operations

	Three Months Ended June 30, 2010				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Net operating revenues	$20.1	$ 346.9	$ 140.1	$(10.2)	$ 496.9
Operating expenses:					
Salaries and benefits	12.7	164.3	67.7	(3.1)	241.6
Other operating expenses	4.5	49.8	26.7	(4.4)	76.6
General and administrative expenses	26.7	-	-	-	26.7
Supplies	1.6	19.8	7.4	-	28.8
Depreciation and amortization	2.8	12.2	3.7	-	18.7
Occupancy costs	0.8	8.7	4.5	(2.6)	11.4
Provision for doubtful accounts	0.5	4.3	1.1	-	5.9
Loss on disposal of assets	-	0.3	0.1	-	0.4
Professional fees—accounting, tax, and legal	5.7	-	-	-	5.7
Total operating expenses	55.3	259.4	111.2	(10.1)	415.8
Loss on early extinguishment of debt	0.1	-	-	-	0.1
Interest expense and amortization of debt discounts and fees	27.7	2.2	0.9	(0.7)	30.1
Other income	(0.3)	(0.1)	(1.7)	0.7	(1.4)
Gain on interest rate swaps	(0.3)	-	-	-	(0.3)
Equity in net income of nonconsolidated affiliates	(0.5)	(2.0)	(0.1)	-	(2.6)
Equity in net income of consolidated affiliates	(44.0)	(2.4)	(1.0)	47.4	-
Management fees	(22.5)	17.3	5.2	-	-
Income from continuing operations before income tax (benefit) expense	4.6	72.5	25.6	(47.5)	55.2
Provision for income tax (benefit) expense	(42.2)	33.1	6.9	-	(2.2)
Income from continuing operations	46.8	39.4	18.7	(47.5)	57.4
Income (loss) from discontinued operations, net of tax	0.5	(0.2)	(0.2)	-	0.1
Net income	47.3	39.2	18.5	(47.5)	57.5
Less: Net income attributable to noncontrolling interests	-	-	(10.2)	-	(10.2)
Net income attributable to HealthSouth	$47.3				