

HEALTHSOUTH CORP

FORM 10-Q

(Quarterly Report)

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Address	3660 GRANDVIEW PARKWAY SUITE 200 BIRMINGHAM, AL 35243
Telephone	205-967-7116
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-Q
 **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2010

OR
**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)

3660 Grandview Parkway, Suite 200
Birmingham, Alabama
(Address of Principal Executive Offices)

63-0860407
(I.R.S. Employer
Identification No.)

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 No

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

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

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

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

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 negative of these 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.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

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

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

HealthSouth Corporation and Subsidiaries
Condensed Consolidated Balance Sheets
(Unaudited)

	<u>June 30, 2010</u>	<u>December 31, 2009</u>
	(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	<u>503.9</u>	<u>426.0</u>
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	<u>\$ 1,756.1</u>	<u>\$ 1,681.5</u>
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	<u>391.4</u>	<u>391.2</u>
Long-term debt, net of current portion	1,633.0	1,641.0
Other long-term liabilities	161.6	159.5
	<u>2,186.0</u>	<u>2,191.7</u>
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	<u>(896.3)</u>	<u>(974.0)</u>
Noncontrolling interests	79.0	76.4
Total shareholders' deficit	<u>(817.3)</u>	<u>(897.6)</u>
Total liabilities and shareholders' deficit	<u>\$ 1,756.1</u>	<u>\$ 1,681.5</u>

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

HealthSouth Corporation and Subsidiaries
Condensed Consolidated Statements of Comprehensive Income
(Unaudited)

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

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									<u>\$ 104.0</u>
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	<u>93.5</u>	<u>\$ 1.0</u>	<u>\$ 2,877.6</u>	<u>\$ (3,629.4)</u>	<u>(4.0)</u>	<u>\$ (141.5)</u>	<u>79.0</u>	<u>\$ (817.3)</u>	

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									<u>\$ 60.8</u>
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	<u>0.3</u>	<u>-</u>	<u>0.1</u>	<u>-</u>	<u>-</u>	<u>(0.6)</u>	<u>(1.3)</u>	<u>(1.8)</u>
Balance at end of period	<u>88.3</u>	<u>\$ 1.0</u>	<u>\$ 2,950.2</u>	<u>\$ (3,772.8)</u>	<u>\$ 0.5</u>	<u>\$ (312.1)</u>	<u>\$ 82.9</u>	<u>\$ (1,050.3)</u>

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

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)

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

	Six Months Ended June 30,	
	2010	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.

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*

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

(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		Six Months Ended	
	June 30,		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

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

\$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 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	Fair Value Measurements at Reporting Date Using				Valuation Technique ⁽¹⁾
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
June 30, 2010						
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

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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):

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
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	<u>\$ 40.8</u>	<u>\$ (12.0)</u>	<u>\$ 75.0</u>	<u>\$ 26.4</u>
Denominator:				
Basic weighted average common shares outstanding	<u>92.8</u>	<u>87.6</u>	<u>92.7</u>	<u>87.5</u>
Diluted weighted average common shares outstanding	<u>108.2</u>	<u>101.5</u>	<u>108.2</u>	<u>101.2</u>
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	<u>\$ 0.44</u>	<u>\$ (0.14)</u>	<u>\$ 0.81</u>	<u>\$ 0.30</u>

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.

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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

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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").

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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.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

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.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

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.

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

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.

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 (In Millions)	Eliminating Entries	HealthSouth Consolidated
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	<u>\$ 47.3</u>	<u>\$ 39.2</u>	<u>\$ 8.3</u>	<u>\$ (47.5)</u>	<u>\$ 47.3</u>

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Operations

	Three Months Ended June 30, 2009				
	<u>HealthSouth Corporation</u>	<u>Guarantor Subsidiaries</u>	<u>Non Guarantor Subsidiaries</u> (In Millions)	<u>Eliminating Entries</u>	<u>HealthSouth Consolidated</u>
Net operating revenues	\$ 19.8	\$ 333.9	\$ 137.1	\$ (9.2)	\$ 481.6
Operating expenses:					
Salaries and benefits	11.5	162.4	67.0	(3.1)	237.8
Other operating expenses	4.6	45.0	21.2	(3.8)	67.0
General and administrative expenses	24.9	-	-	-	24.9
Supplies	1.7	19.4	7.5	-	28.6
Depreciation and amortization	2.2	11.5	3.9	-	17.6
Occupancy costs	1.0	8.9	4.4	(2.3)	12.0
Provision for doubtful accounts	0.7	6.8	2.2	-	9.7
Loss on disposal of assets	-	1.3	-	-	1.3
Government, class action, and related settlements	48.7	-	-	-	48.7
Professional fees—accounting, tax, and legal	(3.3)	-	-	-	(3.3)
Total operating expenses	92.0	255.3	106.2	(9.2)	444.3
Gain on early extinguishment of debt	(1.3)	-	-	-	(1.3)
Interest expense and amortization of debt discounts and fees	28.8	1.9	0.9	(0.5)	31.1
Other income	(0.3)	(0.1)	(1.1)	0.5	(1.0)
Loss on interest rate swaps	3.8	-	-	-	3.8
Equity in net (income) loss of nonconsolidated affiliates	(0.3)	3.1	(0.1)	-	2.7
Equity in net income of consolidated affiliates	(39.7)	(4.8)	(1.0)	45.5	-
Management fees	(21.3)	16.6	4.7	-	-
(Loss) income from continuing operations before income tax (benefit) expense	(41.9)	61.9	27.5	(45.5)	2.0
Provision for income tax (benefit) expense	(36.2)	28.5	7.4	-	(0.3)
(Loss) income from continuing operations	(5.7)	33.4	20.1	(45.5)	2.3
Income (loss) from discontinued operations	0.2	(0.4)	1.5	-	1.3
Net (loss) income	(5.5)	33.0	21.6	(45.5)	3.6
Less: Net income attributable to noncontrolling interests	-	(0.2)	(8.9)	-	(9.1)
Net (loss) income attributable to HealthSouth	\$ (5.5)	\$ 32.8	\$ 12.7	\$ (45.5)	\$ (5.5)

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Operations

	Six Months Ended June 30, 2010				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries (In Millions)	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	\$ 40.9	\$ 688.3	\$ 278.9	\$ (20.2)	\$ 987.9
Operating expenses:					
Salaries and benefits	26.0	328.4	135.3	(6.2)	483.5
Other operating expenses	9.3	95.4	47.6	(8.8)	143.5
General and administrative expenses	53.0	-	-	-	53.0
Supplies	3.2	39.2	14.7	-	57.1
Depreciation and amortization	5.4	24.3	7.3	-	37.0
Occupancy costs	1.9	17.3	8.9	(5.1)	23.0
Provision for doubtful accounts	0.9	9.0	2.9	-	12.8
Loss on disposal of assets	-	0.4	-	-	0.4
Professional fees—accounting, tax, and legal	8.6	-	-	-	8.6
Total operating expenses	108.3	514.0	216.7	(20.1)	818.9
Loss on early extinguishment of debt	0.4	-	-	-	0.4
Interest expense and amortization of debt discounts and fees	55.8	4.4	1.6	(1.2)	60.6
Other income	(0.5)	(0.1)	(2.7)	1.2	(2.1)
Loss on interest rate swaps	4.0	-	-	-	4.0
Equity in net income of nonconsolidated affiliates	(1.2)	(3.9)	(0.1)	-	(5.2)
Equity in net income of consolidated affiliates	(91.4)	(4.2)	(1.8)	97.4	-
Management fees	(44.0)	34.1	9.9	-	-
Income from continuing operations before income tax (benefit) expense	9.5	144.0	55.3	(97.5)	111.3
Provision for income tax (benefit) expense	(80.0)	65.6	14.7	-	0.3
Income from continuing operations	89.5	78.4	40.6	(97.5)	111.0
Loss from discontinued operations, net of tax	(1.5)	(0.8)	(0.8)	0.1	(3.0)
Net income	88.0	77.6	39.8	(97.4)	108.0
Less: Net income attributable to noncontrolling interests	-	-	(20.0)	-	(20.0)
Net income attributable to HealthSouth	\$ 88.0	\$ 77.6	\$ 19.8	\$ (97.4)	\$ 88.0

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Operations

	Six Months Ended June 30, 2009				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries (In Millions)	Eliminating Entries	HealthSouth Consolidated
Net operating revenues	\$ 38.8	\$ 666.4	\$ 267.6	\$ (18.3)	\$ 954.5
Operating expenses:					
Salaries and benefits	25.2	320.6	131.5	(6.2)	471.1
Other operating expenses	8.9	90.8	41.7	(7.5)	133.9
General and administrative expenses	50.4	-	-	-	50.4
Supplies	3.2	38.2	14.6	-	56.0
Depreciation and amortization	4.3	23.0	7.7	-	35.0
Occupancy costs	2.1	17.8	8.7	(4.6)	24.0
Provision for doubtful accounts	1.3	11.8	4.4	-	17.5
Loss on disposal of assets	-	2.2	0.1	-	2.3
Government, class action, and related settlements	32.8	-	-	-	32.8
Professional fees—accounting, tax, and legal	1.5	-	-	-	1.5
Total operating expenses	129.7	504.4	208.7	(18.3)	824.5
Gain on early extinguishment of debt	(3.1)	-	-	-	(3.1)
Interest expense and amortization of debt discounts and fees	60.9	4.1	1.6	(1.1)	65.5
Other income	(0.3)	(0.2)	(1.4)	1.1	(0.8)
Loss on interest rate swaps	8.8	-	-	-	8.8
Equity in net (income) loss of nonconsolidated affiliates	(0.9)	1.3	(0.2)	-	0.2
Equity in net income of consolidated affiliates	(83.8)	(6.4)	(1.8)	92.0	-
Management fees	(42.2)	32.9	9.3	-	-
(Loss) income from continuing operations before income tax (benefit) expense	(30.3)	130.3	51.4	(92.0)	59.4
Provision for income tax (benefit) expense	(72.2)	59.4	13.7	-	0.9
Income from continuing operations	41.9	70.9	37.7	(92.0)	58.5
(Loss) income from discontinued operations, net of tax	(2.5)	-	1.1	-	(1.4)
Net income	39.4	70.9	38.8	(92.0)	57.1
Less: Net income attributable to noncontrolling interests	-	(0.3)	(17.4)	-	(17.7)
Net income attributable to HealthSouth	\$ 39.4	\$ 70.6	\$ 21.4	\$ (92.0)	\$ 39.4

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Balance Sheet

	As of June 30, 2010				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries	Eliminating Entries	HealthSouth Consolidated
	(In Millions)				
Assets					
Current assets:					
Cash and cash equivalents	\$ 170.4	\$ -	\$ 2.2	\$ -	\$ 172.6
Restricted cash	1.3	-	48.4	-	49.7
Accounts receivable, net	9.8	155.3	59.7	-	224.8
Other current assets	49.2	62.2	63.4	(118.0)	56.8
Total current assets	230.7	217.5	173.7	(118.0)	503.9
Property and equipment, net	38.2	474.8	151.5	-	664.5
Goodwill	-	271.9	151.8	-	423.7
Intangible assets, net	0.4	28.7	6.4	-	35.5
Investments in and advances to nonconsolidated affiliates	2.5	24.7	3.8	-	31.0
Other long-term assets	59.7	208.4	71.1	(241.7)	97.5
Intercompany receivable	1,022.6	-	-	(1,022.6)	-
Total assets	\$ 1,354.1	\$ 1,226.0	\$ 558.3	\$ (1,382.3)	\$ 1,756.1
Liabilities and Shareholders' (Deficit) Equity					
Current liabilities:					
Current portion of long-term debt	\$ 9.5	\$ 9.9	\$ 2.1	\$ -	\$ 21.5
Accounts payable	11.3	23.1	12.9	-	47.3
Accrued expenses and other current liabilities	217.5	58.4	63.4	(16.7)	322.6
Total current liabilities	238.3	91.4	78.4	(16.7)	391.4
Long-term debt, net of current portion	1,546.8	81.5	27.7	(23.0)	1,633.0
Other long-term liabilities	77.9	11.2	87.0	(14.5)	161.6
Intercompany payable	-	278.7	1,279.0	(1,557.7)	-
	1,863.0	462.8	1,472.1	(1,611.9)	2,186.0
Commitments and contingencies					
Convertible perpetual preferred stock	387.4	-	-	-	387.4
Shareholders' (deficit) equity					
HealthSouth shareholders' (deficit) equity	(896.3)	763.2	(992.8)	229.6	(896.3)
Noncontrolling interests	-	-	79.0	-	79.0
Total shareholders' (deficit) equity	(896.3)	763.2	(913.8)	229.6	(817.3)
Total liabilities and shareholders' (deficit) equity	\$ 1,354.1	\$ 1,226.0	\$ 558.3	\$ (1,382.3)	\$ 1,756.1

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Balance Sheet

	As of December 31, 2009				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries (In Millions)	Eliminating Entries	HealthSouth Consolidated
Assets					
Current asset :					
Cash and cash equivalents	\$ 76.2	\$ 1.8	\$ 2.9	\$ -	\$ 80.9
Restricted cash	2.3	-	65.5	-	67.8
Accounts receivable, net	10.1	149.5	60.1	-	219.7
Other current assets	35.2	62.1	48.8	(88.5)	57.6
Total current assets	123.8	213.4	177.3	(88.5)	426.0
Property and equipment, net	40.1	479.8	144.9	-	664.8
Goodwill	-	264.6	151.8	-	416.4
Intangible assets, net	0.4	29.4	7.6	-	37.4
Investments in and advances to nonconsolidated affiliates	3.0	22.4	3.9	-	29.3
Other long-term assets	65.4	209.0	79.5	(246.3)	107.6
Intercompany receivable	1,053.0	-	-	(1,053.0)	-
Total assets	\$ 1,285.7	\$ 1,218.6	\$ 565.0	\$ (1,387.8)	\$ 1,681.5
Liabilities and Shareholders' (Deficit) Equity					
Current liabilities:					
Current portion of long-term debt	\$ 9.7	\$ 10.0	\$ 1.8	\$ -	\$ 21.5
Accounts payable	12.5	28.1	9.6	-	50.2
Accrued expenses and other current liabilities	213.8	48.5	57.2	-	319.5
Total current liabilities	236.0	86.6	68.6	-	391.2
Long-term debt, net of current portion	1,552.9	86.1	27.0	(25.0)	1,641.0
Other long-term liabilities	83.4	11.3	69.5	(4.7)	159.5
Intercompany payable	-	372.0	1,448.0	(1,820.0)	-
	1,872.3	556.0	1,613.1	(1,849.7)	2,191.7
Commitments and contingencies					
Convertible perpetual preferred stock	387.4	-	-	-	387.4
Shareholders' (deficit) equity					
HealthSouth shareholders' (deficit) equity	(974.0)	662.6	(1,124.5)	461.9	(974.0)
Noncontrolling interests	-	-	76.4	-	76.4
Total shareholders' (deficit) equity	(974.0)	662.6	(1,048.1)	461.9	(897.6)
Total liabilities and shareholders' (deficit) equity	\$ 1,285.7	\$ 1,218.6	\$ 565.0	\$ (1,387.8)	\$ 1,681.5

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Cash Flows

	Six Months Ended June 30, 2010				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries (In Millions)	Eliminating Entries	HealthSouth Consolidated
Net cash provided by operating activities	\$ 65.8	\$ 133.3	\$ 72.7	\$ (99.1)	\$ 172.7
Cash flows from investing activities:					
Capital expenditures	(3.5)	(15.6)	(10.8)	-	(29.9)
Acquisition of a business, net of cash acquired	-	(9.9)	-	-	(9.9)
Proceeds from sale of restricted investments	-	-	10.0	-	10.0
Purchase of restricted investments	-	-	(13.3)	-	(13.3)
Net change in restricted cash	1.0	-	17.1	-	18.1
Net settlements on interest rate swaps	(23.1)	-	-	-	(23.1)
Other	-	(0.1)	-	-	(0.1)
Net cash provided by investing activities of discontinued operations	-	-	8.5	-	8.5
Net cash (used in) provided by investing activities	(25.6)	(25.6)	11.5	-	(39.7)
Cash flows from financing activities:					
Principal payments on debt, including pre-payments	(5.8)	-	-	2.0	(3.8)
Principal payments under capital lease obligations	(1.1)	(5.1)	(1.0)	-	(7.2)
Dividends paid on convertible perpetual preferred stock	(13.0)	-	-	-	(13.0)
Distributions paid to noncontrolling interests of consolidated affiliates	-	-	(18.3)	-	(18.3)
Other	0.3	-	0.6	-	0.9
Change in intercompany advances	73.6	(104.4)	(66.3)	97.1	-
Net cash provided by (used in) financing activities	54.0	(109.5)	(85.0)	99.1	(41.4)
Increase (decrease) in cash and cash equivalents	94.2	(1.8)	(0.8)	-	91.6
Cash and cash equivalents at beginning of period	76.2	1.8	2.9	-	80.9
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	\$ 170.4	\$ -	\$ 2.2	\$ -	\$ 172.6

HealthSouth Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements

Condensed Consolidating Statement of Cash Flows

	Six Months Ended June 30, 2009				
	HealthSouth Corporation	Guarantor Subsidiaries	Non Guarantor Subsidiaries (In Millions)	Eliminating Entries	HealthSouth Consolidated
Net cash provided by operating activities	\$ 137.0	\$ 130.4	\$ 56.8	\$ (95.0)	\$ 229.2
Cash flows from investing activities:					
Capital expenditures	(4.5)	(25.3)	(4.6)	-	(34.4)
Proceeds from sale of restricted investments	-	-	1.6	-	1.6
Purchase of restricted investments	-	-	(1.6)	-	(1.6)
Net change in restricted cash	(0.5)	-	(15.2)	-	(15.7)
Net settlements on interest rate swaps	(19.1)	-	-	-	(19.1)
Net investment in interest rate swap	(6.4)	-	-	-	(6.4)
Other	-	0.8	(1.6)	-	(0.8)
Net cash provided by (used in) investing activities of discontinued operations	0.1	-	(1.5)	-	(1.4)
Net cash used in investing activities	(30.4)	(24.5)	(22.9)	-	(77.8)
Cash flows from financing activities:					
Principal payments on debt, including pre-payments	(62.7)	(0.2)	-	2.0	(60.9)
Borrowings on revolving credit facility	10.0	-	-	-	10.0
Payments on revolving credit facility	(50.0)	-	-	-	(50.0)
Principal payments under capital lease obligations	(0.1)	(4.8)	(1.7)	-	(6.6)
Dividends paid on convertible perpetual preferred stock	(13.0)	-	-	-	(13.0)
Distributions paid to noncontrolling interests of consolidated affiliates	-	-	(15.8)	-	(15.8)
Other	(0.1)	-	0.8	-	0.7
Change in intercompany advances	32.9	(100.9)	(25.0)	93.0	-
Net cash (used in) provided by financing activities of discontinued operations	(0.5)	0.1	2.2	-	1.8
Net cash used in financing activities	(83.5)	(105.8)	(39.5)	95.0	(133.8)
Increase (decrease) in cash and cash equivalents	23.1	0.1	(5.6)	-	17.6
Cash and cash equivalents at beginning of period	23.1	0.8	8.2	-	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	\$ 46.2	\$ 0.9	\$ 2.7	\$ -	\$ 49.8

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

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) relates to HealthSouth Corporation and its subsidiaries and should be read in conjunction with our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report and our audited consolidated financial statements for the year ended December 31, 2009 and *Management’s Discussion and Analysis of Financial Condition and Results of Operations* which are included in our Annual Report on Form 10-K for the year ended December 31, 2009 (the “2009 Form 10-K”). As used in this report, the terms “HealthSouth,” “we,” “our,” “us,” and the “Company” refer to HealthSouth Corporation and its subsidiaries, unless otherwise stated or indicated by context.

This MD&A is designed to provide the reader with information that will assist in understanding our condensed consolidated financial statements, the changes in certain key items in those financial statements from period to period, and the primary factors that accounted for those changes, as well as how certain accounting principles affect our condensed consolidated financial statements.

Executive Overview

Our Business

We operate inpatient rehabilitation hospitals and long-term acute care hospitals (“LTCHs”) and provide treatment on both an inpatient and outpatient basis. As of June 30, 2010, we operated 95 inpatient rehabilitation hospitals (including 3 hospitals that operate as joint ventures which we account for using the equity method of accounting), 6 freestanding LTCHs, 38 outpatient rehabilitation satellite clinics (operated by our hospitals, including one joint venture satellite), and 25 licensed, hospital-based home health agencies. In addition to HealthSouth hospitals, we manage four inpatient rehabilitation units through management contracts. Our inpatient hospitals are located in 26 states and Puerto Rico, with a concentration of hospitals in Texas, Pennsylvania, Florida, Tennessee, Alabama, and Arizona.

We are the nation’s largest provider of inpatient rehabilitative healthcare services in terms of revenues, number of hospitals, and patients treated and discharged. Our inpatient rehabilitation hospitals offer specialized rehabilitative care across a wide array of diagnoses and deliver comprehensive, high-quality, cost-effective patient care services. The majority of patients we serve experience significant physical disabilities due to medical conditions, such as strokes, hip fractures, head injury, spinal cord injury, and neurological disorders, that are generally non-discretionary in nature and which require rehabilitative healthcare services in an inpatient setting. Our team of highly skilled physicians, nurses, and physical, occupational, and speech therapists utilize the latest in equipment and techniques to return patients to home and work. Patient care is provided by nursing and therapy staff as directed by a physician order. Internal case managers monitor each patient’s progress and provide documentation of patient status, achievement of goals, discharge planning, and functional outcomes. Our hospitals provide a comprehensive interdisciplinary clinical approach to treatment that leads to what we believe is a higher level of care and superior outcomes.

Net patient revenue from our hospitals was 4.3% and 4.6% higher for the three and six months ended June 30, 2010 than the same periods of 2009 due to higher net patient revenue per discharge and a 2.2% and 1.7% increase in patient discharges, respectively. Operating earnings (as defined in Note 24, *Quarterly Data (Unaudited)*, to the consolidated financial statements accompanying the 2009 Form 10-K) were \$73.5 million and \$154.2 million for the three and six months ended June 30, 2010, respectively, compared to \$25.7 million and \$112.6 million for the three and six months ended June 30, 2009, respectively. Operating earnings for the three and six months ended June 30, 2009 included a net charge of \$48.7 million and \$32.8 million, respectively, associated with *Government, class action, and related settlements*, as discussed below. *Net cash provided by operating activities* was \$172.7 million and \$229.2 million for the six months ended June 30, 2010 and 2009, respectively. *Net cash provided by operating activities* for the six months ended June 30, 2010 included \$9.7 million of state income tax refunds associated with prior periods. *Net cash provided by operating activities* for the six months ended June 30, 2009 included \$73.8 million in net cash proceeds related to the UBS Settlement and the receipt of \$54.0 million in federal and state income tax refunds for prior periods. See the “Results of Operations” and “Liquidity and Capital Resources” sections of this item for additional information.

On June 1, 2010, we finalized our previously announced purchase of Desert Canyon Rehabilitation Hospital, a 50-bed inpatient rehabilitation hospital located in southwest Las Vegas, Nevada. In addition, our newly built 40-bed hospital in Loudon County, Virginia began accepting patients on June 14, 2010. Our development activities have continued in the third quarter of 2010. We expect our new 25-bed, joint venture hospital in Bristol, Virginia to begin accepting patients in August 2010. In addition, we have announced two additional development transactions including (1) the signing of a contract to purchase land and to begin construction in the fourth quarter of a new, 40-bed inpatient rehabilitation hospital in the Cypress area of northwest Houston, Texas and (2) the signing of a definitive agreement to purchase Sugar Land Rehabilitation Hospital, a 50-bed inpatient rehabilitation hospital located in southwest Houston, Texas.

As discussed in the “Business Outlook” section below, our ability to continue to create shareholder value in the near term will be predicated on our ability to: (1) deleverage our balance sheet; (2) grow organically; (3) provide high-quality, cost-effective care; (4) pursue acquisitions on a disciplined, opportunistic basis; and (5) adapt to regulatory changes affecting our industry. We believe the demand for inpatient rehabilitative healthcare services will increase as the U.S. population ages. In addition, the number of patients who qualify for inpatient rehabilitative care under Medicare rules is expected to grow approximately 2% per year for the foreseeable future, creating an attractive market. We believe these market factors align with our strengths in, and focus on, inpatient rehabilitative care. Unlike many of our competitors that may offer inpatient rehabilitation as one of many secondary services, inpatient rehabilitation is our core business.

Key Challenges

While we are pleased with the Company’s performance thus far in 2010, the following are some of the challenges we are addressing:

- Leverage . Further deleveraging and strengthening of our capital structure is a strategic focus. One measure we use to assess our financial leverage is the ratio of consolidated total debt to Adjusted Consolidated EBITDA.

Debt repayment priorities are established based upon a number of factors including maturity dates, coupon rates, prepayment penalties and call protection features, trading levels in the secondary markets, and affirmative and restrictive covenants. We monitor changes in these factors on an on-going basis. We believe continued growth in our Adjusted Consolidated EBITDA and our strong cash flows from operations will allow us to continue to reduce our leverage and invest in growth opportunities. For additional information, see the “Executive Overview – Business Outlook” and “Liquidity and Capital Resources” sections of this Item. See also Item 1A, *Risk Factors* , and Note 1, *Summary of Significant Accounting Policies* , to the consolidated financial statements accompanying the 2009 Form 10-K for a discussion of risks and uncertainties facing us.

- Highly Regulated Industry . We are required to comply with extensive and complex laws and regulations at the federal, state, and local government levels. These rules and regulations have affected, or could in the future affect, our business activities by controlling the reimbursement we receive for services provided, requiring licensure or certification of our hospitals, regulating our relationships with physicians and other referral sources, regulating the use of our properties, and controlling our growth. Ensuring continuous compliance with these laws and regulations is an operating requirement for all healthcare providers.

Over the last several years, changes in regulations governing inpatient rehabilitation hospitals have created challenges for inpatient rehabilitation providers with many of these changes resulting in limitations on, and in some cases reductions to, reimbursement from Medicare, including reductions to the annual “market basket update” (i.e., annual adjustment to Medicare payment rates).

On August 7, 2009, the Centers for Medicare and Medicaid Services (“CMS”) published in the federal register the fiscal year 2010 notice of final rulemaking (the “2010 Rule”) for inpatient rehabilitation facilities (“IRFs”) under the prospective payment system (“IRF-PPS”). The 2010 Rule contains Medicare pricing changes as well as changes to coverage requirements, as described below. The pricing changes were effective for Medicare discharges between October 1, 2009 and September 30, 2010

and included a 2.5% market basket update, which was the first market basket update we had received in 18 months. However, as discussed below, on March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act (the “PPACA”) into law. On March 30, 2010, President Obama signed into law the Health Care and Education Affordability Reconciliation Act of 2010, which amended the PPACA (together, the “2010 Healthcare Reform Laws”). These laws include a reduction in annual market basket updates to providers. Starting on April 1, 2010, the market basket increase of 2.5% we received on October 1, 2009 was reduced by 0.25% to 2.25%. Similar reductions to our annual market basket updates are scheduled to occur each year through 2019, although the amount of each year’s decrease will vary over time.

The coverage requirements under the 2010 Rule apply to discharges occurring on or after January 1, 2010 and include requirements for preadmission screening, post-admission evaluations, and individual treatment planning that all emphasize the role of physicians in ordering and overseeing patient care. Although these changes have not resulted in material modifications to our clinical or business models, they have resulted in increased procedural and documentation requirements for our hospitals. In addition, due to the complexity of the changes within the 2010 Rule, CMS continues to clarify the revised coverage requirements. We have undertaken efforts to educate our employees and affiliated physicians on compliance with these requirements, and we will continue to train our employees as the requirements are further clarified.

In addition, on July 22, 2010, CMS published in the federal register its IRF-PPS notice for fiscal year 2011 (the “2011 Rule”). The 2011 Rule will be effective for Medicare discharges between October 1, 2010 and September 30, 2011. The pricing changes in this rule include a 2.5% market basket update that will be reduced by 0.25% to 2.25% under the requirements of the 2010 Healthcare Reform Laws discussed above, as well as other pricing changes that impact our hospital-by-hospital base rate for Medicare reimbursement. Based on our preliminary analysis which utilizes the acuity of our patients over the last twelve months, we believe the 2011 Rule will have a net positive impact on our *Net operating revenues*.

Our outpatient services are primarily reimbursed under Medicare’s physician fee schedule. On July 13, 2010, CMS published in the federal register its proposed rule for the Medicare Physician Fee Schedule for calendar year 2011 that would update pricing for outpatient therapy services. Under the proposed rule, CMS has proposed to implement a 50% rate reduction for reimbursement of therapy expenses for secondary procedures when multiple therapy services are provided on the same day. While we would look to mitigate the impact of this proposal to our earnings, we currently estimate this proposal would decrease our *Net operating revenues* by approximately \$4 million annually, beginning in 2011. In addition, there are several other potential pricing changes, both positive and negative, proposed in this rule, including an approximate 27% reduction in payments made under the Medicare Physician Fee Schedule. If Congress does not act to set aside implementation of these reductions to the physician fee schedule, as they have done in the past, we currently estimate the remaining pricing changes would have a negative impact of an additional approximate \$6 million to our *Net operating revenues* annually, beginning in 2011. We cannot predict what, if any, action Congress will take on the physician fee schedule, and we cannot predict how future Congressional action or inaction on the physician fee schedule will affect us.

There have also been several recent CMS initiatives focused on all of the nation’s IRFs as a result of the Department of Health and Human Services’ Office of Inspector General’s (the “OIG”) annual work plans. One of these initiatives includes a nationwide review of IRFs’ transmission of patient assessment instruments (“PAIs”) for calendar years 2006 and 2007. To administer the prospective payment system, CMS requires IRFs to electronically transmit a patient assessment instrument for each IRF stay to CMS’s National Assessment Collection Database (the “Database”). The date the PAI was transmitted to the Database is included on the submission sent to the fiscal intermediary for payment. If an IRF transmits the PAI more than 27 calendar days from the beneficiary’s discharge date, the IRF’s payment rate for the applicable case-mix group should be reduced by 25%. Therefore, the objective of the OIG’s review was, and still is, to determine whether IRFs received reduced case-mix-group payments for claims with PAIs that were transmitted late. The initial nationwide

audit of all IRFs covered over 10,000 claims totaling \$166 million. From this pool of national claims, 200 claims were reviewed with 113 claims being noted with late transmissions of PAIs for an estimated \$20.2 million in overpayments. We have reviewed our internal processes for transmitting PAIs and do not believe this audit of PAIs will significantly impact our operations, as our operating procedures are designed to ensure PAIs are transmitted within the appropriate timeframe.

In addition, the OIG recently issued an audit report on all of the nation's IRFs regarding improperly coded claims associated with coding rules governing transfer cases. Pursuant to Medicare's transfer regulation, Medicare pays the full prospective payment to an IRF that discharges a beneficiary to home, while it pays a lesser amount, based on a per diem rate and the number of days the beneficiary spent in the IRF, for a transfer case. The audit identified overpayments to transferring IRFs that did not comply with Medicare's transfer regulation. Based on the audit's sample results, the OIG estimates the nation's IRFs were overpaid approximately \$34 million during the four-year period ended September 30, 2007. As part of its requests of all of the nation's IRFs, the OIG has requested a limited number of documents from us in order to validate our proper use of this transfer code during calendar year 2007. Based on our analysis and review of the requested information, we do not believe this audit will have a material impact on our financial position, results of operations, or cash flows.

We have invested substantial time, effort, and expense in implementing internal controls and procedures designed to ensure regulatory compliance, and we are committed to continued adherence to these guidelines. More specifically, because Medicare comprises a significant portion of our *Net operating revenues*, it is important for us to remain compliant with the laws and regulations governing the Medicare program and related matters including anti-kickback and anti-fraud requirements. If we were unable to remain compliant with these regulations, our financial position, results of operations, and cash flows could be materially, adversely impacted.

See also Item 1, *Business*, "Sources of Revenue" and "Regulation," to the 2009 Form 10-K.

- Healthcare Reform. Many issues within the context of healthcare reform are addressed within the 2010 Healthcare Reform Laws and could have an impact on our business, including: (1) reducing annual market basket updates to providers, (2) the possible combining, or "bundling," of acute care hospital and post-acute Medicare reimbursement at some point in the future, and (3) creating an Independent Payment Advisory Board.

Most notably for HealthSouth, these laws include a reduction in annual market basket updates to providers. Starting on April 1, 2010, the market basket update of 2.5% we received on October 1, 2009 was reduced by 0.25% to 2.25%. Similar reductions to our annual market basket update will occur each year through 2019, although the amount of each year's decrease will vary over time. In addition, beginning on October 1, 2011, the 2010 Healthcare Reform Laws require an additional to-be determined productivity adjustment to the market basket update on an annual basis.

The 2010 Healthcare Reform Laws also direct the Department of Health and Human Services to examine the feasibility of bundling, including conducting a voluntary bundling pilot program to test and evaluate alternative payment methodologies. The possibility of implementing bundling on a program-wide basis is difficult to predict at this time and will be affected by the outcomes of the various pilot projects conducted. In addition, if bundling were to be implemented, it would require numerous modifications to, or repeal of, various federal and state laws, regulations, and policies. These pilot projects are scheduled to begin no later than January 2013 and are limited in scope to ten medical conditions. We will seek to participate in these pilot projects.

Another provision of these laws establishes an Independent Payment Advisory Board that is charged with presenting proposals to Congress to reduce Medicare expenditures upon the occurrence of Medicare expenditures exceeding a certain level. However, due to the market basket reductions through 2019 that are also part of these laws (as discussed above), certain healthcare providers, including HealthSouth, will not be subject to payment reduction proposals developed by this board and presented to Congress through 2019. While we may not be subject to payment reduction proposals by this board for a period of time, based on the scope of this board's directive to reduce Medicare expenditures and the significance of Medicare as a payor to us, other decisions made by this board may impact our results of operations either positively or negatively.

In addition to these factors, the 2010 Healthcare Reform Laws also contain provisions that will require modifications to employer-sponsored healthcare insurance plans, including HealthSouth plans. For example, the 2010 Healthcare Reform Laws require employer-sponsored healthcare plans to offer coverage to an employee's dependent children until such dependents attain the age of 26. In addition, these laws eliminate an employer's ability to include a lifetime maximum benefit per participant within its plans. We continue to evaluate the impact these changes will have on our healthcare plans and related costs.

Given the complexity and the number of changes in these laws, as well as the implementation timetable for many of them, we cannot predict the ultimate impact of these laws. However, we believe the above points are the issues with the greatest potential impact on us. We will continue to evaluate and review these laws, and, based on our track record, we believe we can adapt to these regulatory changes.

- **Staffing** . Our operations are dependent on the efforts, abilities, and experience of our medical personnel, such as physical therapists, occupational therapists, speech pathologists, nurses, and other healthcare professionals. In some markets, the lack of availability of medical personnel is an operating issue facing all healthcare providers, although the weak economy has mitigated this issue to some degree. We have refined our comprehensive benefits package to remain competitive in this challenging staffing environment while also being consistent with our goal of being a high-quality, cost-effective provider of inpatient rehabilitative services. As a result of our efforts, we are experiencing improved retention rates and reduced turnover. Going forward, recruiting and retaining qualified personnel for our hospitals will remain a high priority for us.

We continue to monitor efforts in Congress that could make it more difficult for employees to avoid or reject labor organization. At this time, it is not clear whether, when, or in what form, such legislation might be enacted into law, nor are we able to predict the impact, if any, this legislation would have on our business, if enacted.

Business Outlook

As previously noted, the inpatient rehabilitation sector of the healthcare industry is an attractive market: the aging of the U.S. population coupled with an approximate 2% projected annual growth rate in the number of patients who qualify for inpatient rehabilitative care under Medicare rules create a favorable business environment for us. As the nation's largest provider of inpatient rehabilitative healthcare services, we believe we differentiate ourselves from our competitors based on our broad base of clinical expertise, the quality of our clinical outcomes, the application and leverage of rehabilitative technology, and the standardization of best practices that result in high-quality, cost-effective care for the patients we serve.

Our ability to continue to create shareholder value in the near term will be predicated on our ability to: (1) deleverage our balance sheet; (2) grow organically; (3) provide high-quality, cost-effective care; (4) pursue acquisitions on a disciplined, opportunistic basis; and (5) adapt to regulatory changes affecting our industry.

Our deleveraging efforts are currently focused on growing Adjusted Consolidated EBITDA through organic growth and disciplined expansion. Our organic growth will result from increasing our market share of inpatient discharges, actively managing expenses, and pursuing capacity expansions in existing hospitals to meet growing demand in certain markets. In addition to organic growth, we will continue to look for appropriate markets for de-novo sites, acquisitions, and joint ventures. We believe growth in our Adjusted Consolidated EBITDA and our strong cash flows from operations will allow us to continue to reduce our leverage. Further, we believe we have adequate sources of liquidity due to our *Cash and cash equivalents*, cash flows from operations, and the availability of our revolving credit facility. In addition, and as discussed in the "Liquidity and Capital Resources" section of this Item, we do not face near-term refinancing risk.

We believe our ability to continue to grow at a faster rate than the rest of the industry is attributable to our higher level of care and is sustainable. In addition, the majority of patients we serve have medical conditions, such as strokes, hip fractures, and neurological disorders, that are generally non-discretionary in nature and which require rehabilitative services in an inpatient setting.

Healthcare providers are under increasing pressure to control costs. We take this challenge seriously and pride ourselves in our ability to provide high-quality, cost-effective care. We will continue to focus on ensuring we provide high-quality care and finding efficiencies in our cost structure at both the corporate and operational levels in an effort to remain competitive. With this in mind, we are making certain investments in our core business in 2010. One investment is the piloting of an electronic clinical information system in our new hospital in Loudoun County, Virginia. This is an initial two-year pilot program with the goal of developing system content as well as gaining a better understanding of the value proposition of a potential company-wide implementation. In addition, we will continue our company-wide initiative of developing best practices for different components of our operational structure by making an investment in our case management function. Our case managers are critical to our delivery system, as they coordinate the care plan and communication among the patient, the patient's family, treatment team, and payors. In addition to these investments, our expenses may outpace revenues for a short period while we bring both acquired and de-novo hospitals online.

Our largest costs are our *Salaries and benefits*, and they represent our investment in our most valuable resource: our employees. We will continue to monitor the labor market and will make any necessary adjustments to remain competitive in this challenging environment while also being consistent with our goal of being a high-quality, cost-effective provider of inpatient rehabilitative services.

As discussed previously, healthcare has long been a highly regulated industry, and the inpatient rehabilitation sector is no exception. Successful healthcare providers are those who provide high-quality care and have the capabilities to adapt to changes in the regulatory environment. We believe we have the necessary capabilities – scale, infrastructure, and management – to adapt and succeed in a highly regulated industry, and we have a proven track record of being able to do so. We are confident, based on our track record, we will be able to adapt to whatever changes may impact our industry, including those discussed above related to healthcare reform.

Although we believe HealthSouth's business outlook is positive, we continue to monitor the economic and regulatory climates and focus on initiatives designed to control costs. We anticipate we will be able to continue to generate strong cash flows that will be directed toward opportunistic, disciplined expansion and growth of our inpatient business and debt reduction, which we believe will bring long-term, sustainable growth and returns to our stockholders.

Results of Operations

During the three and six months ended June 30, 2010 and 2009, we derived consolidated *Net operating revenues* from the following payor sources:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Medicare	69.6%	67.2%	70.0%	67.5%
Medicaid	1.8%	2.2%	1.8%	2.2%
Workers' compensation	1.7%	1.5%	1.6%	1.6%
Managed care and other discount plans	21.9%	23.8%	21.8%	23.1%
Other third-party payors	2.4%	2.7%	2.3%	3.0%
Patients	1.3%	1.1%	1.2%	1.1%
Other income	1.3%	1.5%	1.3%	1.5%
Total	100.0%	100.0%	100.0%	100.0%

Our payor mix is weighted heavily towards Medicare. Our hospitals receive Medicare reimbursements under IRF-PPS. Under IRF-PPS, our hospitals receive fixed payment amounts per discharge based on certain rehabilitation impairment categories established by the United States Department of Health and Human Services. Under IRF-PPS, our hospitals retain the difference, if any, between the fixed payment from Medicare and their operating costs. Thus, our hospitals benefit from being high-quality, low-cost providers. For additional information regarding Medicare reimbursement, please see the "Sources of Revenues" section of Item 1, *Business*, of the 2009 Form 10-K.

Under IRF-PPS, hospitals are reimbursed on a “per discharge” basis. Thus, the number of patient discharges is a key metric utilized by management to monitor and evaluate our performance. The number of outpatient visits is also tracked in order to measure the volume of outpatient activity each period.

For the three and six months ended June 30, 2010 and 2009, our consolidated results of operations were as follows:

	Three Months Ended June 30,		Percentage Change 2010 vs. 2009	Six Months Ended June 30,		Percentage Change 2010 vs. 2009
	2010	2009		2010	2009	
	(In Millions)			(In Millions)		
Net operating revenues	\$ 496.9	\$ 481.6	3.2%	\$ 987.9	\$ 954.5	3.5%
Operating expenses:						
Salaries and benefits	241.6	237.8	1.6%	483.5	471.1	2.6%
Other operating expenses	76.6	67.0	14.3%	143.5	133.9	7.2%
General and administrative expenses	26.7	24.9	7.2%	53.0	50.4	5.2%
Supplies	28.8	28.6	0.7%	57.1	56.0	2.0%
Depreciation and amortization	18.7	17.6	6.3%	37.0	35.0	5.7%
Occupancy costs	11.4	12.0	(5.0%)	23.0	24.0	(4.2%)
Provision for doubtful accounts	5.9	9.7	(39.2%)	12.8	17.5	(26.9%)
Loss on disposal of assets	0.4	1.3	(69.2%)	0.4	2.3	(82.6%)
Government, class action, and related settlements	-	48.7	(100.0%)	-	32.8	(100.0%)
Professional fees—accounting, tax, and legal	5.7	(3.3)	(272.7%)	8.6	1.5	473.3%
Total operating expenses	415.8	444.3	(6.4%)	818.9	824.5	(0.7%)
Loss (gain) on early extinguishment of debt	0.1	(1.3)	(107.7%)	0.4	(3.1)	(112.9%)
Interest expense and amortization of debt discounts and fees	30.1	31.1	(3.2%)	60.6	65.5	(7.5%)
Other income	(1.4)	(1.0)	40.0%	(2.1)	(0.8)	162.5%
(Gain) loss on interest rate swaps	(0.3)	3.8	(107.9%)	4.0	8.8	(54.5%)
Equity in net (income) loss of nonconsolidated affiliates	(2.6)	2.7	(196.3%)	(5.2)	0.2	(2,700.0%)
Income from continuing operations before income tax (benefit) expense	55.2	2.0	2,660.0%	111.3	59.4	87.4%
Provision for income tax (benefit) expense	(2.2)	(0.3)	633.3%	0.3	0.9	(66.7%)
Income from continuing operations	57.4	2.3	2,395.7%	111.0	58.5	89.7%
Income (loss) from discontinued operations, net of tax	0.1	1.3	(92.3%)	(3.0)	(1.4)	114.3%
Net income	57.5	3.6	1,497.2%	108.0	57.1	89.1%
Less: Net income attributable to noncontrolling interests	(10.2)	(9.1)	12.1%	(20.0)	(17.7)	13.0%
Net income (loss) attributable to HealthSouth	\$ 47.3	\$ (5.5)	(960.0%)	\$ 88.0	\$ 39.4	123.4%

Operating Expenses as a % of Net Operating Revenues

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Salaries and benefits	48.6%	49.4%	48.9%	49.4%
Other operating expenses	15.4%	13.9%	14.5%	14.0%
General and administrative expenses	5.4%	5.2%	5.4%	5.3%
Supplies	5.8%	5.9%	5.8%	5.9%
Depreciation and amortization	3.8%	3.7%	3.7%	3.7%
Occupancy costs	2.3%	2.5%	2.3%	2.5%
Provision for doubtful accounts	1.2%	2.0%	1.3%	1.8%
Loss on disposal of assets	0.1%	0.3%	0.0%	0.2%
Government, class action, and related settlements	0.0%	10.1%	0.0%	3.4%
Professional fees—accounting, tax, and legal	1.1%	(0.7%)	0.9%	0.2%
Total	83.7%	92.3%	82.9%	86.4%

Additional information regarding our operating results for the three and six months ended June 30, 2010 and 2009 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
(In Millions)				
Net patient revenue—inpatient	\$ 456.2	\$ 437.2	\$ 908.1	\$ 868.5
Net patient revenue—outpatient and other revenues	40.7	44.4	79.8	86.0
Net operating revenues	\$ 496.9	\$ 481.6	\$ 987.9	\$ 954.5

(Actual Amounts)				
Discharges	29,016	28,379	57,014	56,078
Outpatient visits	265,628	291,944	521,073	575,565
Average length of stay	14.1 days	14.4 days	14.4 days	14.5 days
Occupancy %	67.4%	69.4%	67.6%	69.6%
# of licensed beds at June 30	6,684	6,454	6,684	6,454
Full-time equivalents*	15,600	15,590	15,508	15,529

* Excludes 395 and 388 full-time equivalents for the three months ended June 30, 2010 and 2009, respectively, and 395 and 392 full-time equivalents for the six months ended June 30, 2010 and 2009, respectively, who are considered part of corporate overhead with their salaries and benefits included in *General and administrative expenses* in our condensed consolidated statements of operations. Full-time equivalents included in the above table represent HealthSouth employees who participate in or support the operations of our hospitals and exclude an estimate of full-time equivalents related to contract labor.

Our occupancy percentage has decreased in 2010 due to the addition of 230 newly licensed beds, including 90 beds that came on-line in June 2010, as discussed above.

In the discussion that follows, we use “same store” comparisons to explain the changes in certain performance metrics and line items within our financial statements. We calculate same store comparisons based on hospitals open throughout both the full current periods and prior periods presented. These comparisons include the financial results of market consolidation transactions in existing markets, as it is difficult to determine, with precision, the incremental impact of these transactions on our results of operations.

Net Operating Revenues

Our consolidated *Net operating revenues* consist primarily of revenues derived from patient care services. *Net operating revenues* also include other revenues generated from management and administrative fees and other non-patient care services. These other revenues approximated 1.3% and 1.5% of consolidated *Net operating revenues* for the three months ended June 30, 2010 and 2009, respectively, and 1.3% and 1.5% of consolidated *Net operating revenues* for the six months ended June 30, 2010 and 2009, respectively.

Net patient revenue from our hospitals was 4.3% higher for the three months ended June 30, 2010 than the three months ended June 30, 2009. This increase was attributable to higher net patient revenue per discharge and a 2.2% increase in patient discharges. Net patient revenue per discharge increased quarter over quarter primarily due to the pricing changes that are part of the 2010 Rule, as discussed above. Same store discharges were 1.3% higher quarter over quarter.

Net patient revenue from our hospitals was 4.6% higher for the six months ended June 30, 2010 than the six months ended June 30, 2009 due to the same reasons discussed above for the quarter-over-quarter increase. Patient discharges increased 1.7% during the six months ended June 30, 2010 compared to the same period of 2009. Same store discharges were 0.8% higher period over period for the six months.

Decreased outpatient volumes in both periods resulted primarily from the closure of outpatient satellites in prior periods. For the six-month period ended June 30, 2010, outpatient visit cancellations caused by the severe winter storms in some of our northeast and mid-Atlantic markets in the first quarter of 2010 also contributed to the decreased volume. Challenges in securing therapy staffing in certain markets and continued competition from physicians offering physical therapy services within their own offices also contributed to the decline. As of June 30, 2010, we operated 38 outpatient satellite clinics, while as of June 30, 2009, we operated 44 outpatient satellite clinics.

As discussed above, the market basket increase of 2.5% we received on October 1, 2009 was reduced by 0.25% to 2.25% effective April 1, 2010. As also discussed above, we will receive a market basket update of 2.5% under the 2011 Rule effective October 1, 2010. However, this market basket update will be reduced by 0.25% to 2.25% under the requirements of the 2010 Healthcare Reform Laws.

Salaries and Benefits

Salaries and benefits represent the most significant cost to us and represent an investment in our most important asset: our employees. *Salaries and benefits* include all amounts paid to full - and part-time employees who directly participate in or support the operations of our hospitals, including all related costs of benefits provided to employees. It also includes amounts paid for contract labor.

We actively manage the productive portion of our *Salaries and benefits* utilizing certain metrics, including employees per occupied bed, or “EPOB.” This metric is determined by dividing the number of full-time equivalents, including an estimate of full-time equivalents from the utilization of contract labor, by the number of occupied beds during each period. The number of occupied beds is determined by multiplying the number of licensed beds by our occupancy percentage. Our EPOB decreased from 3.51 and 3.49 during the three and six months ended June 30, 2009, respectively, to 3.48 and 3.45 during the three and six months ended June 30, 2010, respectively. This represents an improvement of 0.9% and 1.1% for the quarter and year-to-date periods, respectively.

Salaries and benefits increased in both 2010 periods presented primarily as a result of an approximate 2.3% merit increase provided to employees on October 1, 2009 and a change in the mix of licensed versus non-licensed employees. The process of standardizing our labor practices across all of our hospitals, which we began last year with the roll-out of a new labor management system, and the implementation of the new coverage requirements that became effective January 1, 2010 have decreased the use of non-licensed employees, which increased our average cost per full-time equivalent. However, continued improvement in labor productivity, a \$1.2 million reduction in self-insured workers' compensation costs due to revised actuarial estimates in the second quarter of 2010, and the Medicare pricing changes that became effective on October 1, 2009 allowed us to decrease these expenses by 80 basis points and 50 basis points as a percent of *Net operating revenues* in the quarter and year-to-date periods, respectively.

Other Operating Expenses

Other operating expenses include costs associated with managing and maintaining our hospitals. These expenses include such items as contract services, utilities, insurance, professional fees, and repairs and maintenance.

Other operating expenses increased in both 2010 periods over the same periods of 2009 due primarily to an increase in self-insurance costs. As a result of the jury verdict discussed in Note 8, *Contingencies*, "Other Litigation," to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report, we recorded a \$4.6 million charge to *Other operating expenses* for the three and six months ended June 30, 2010. In addition, we update our actuarial estimates surrounding our self-insurance reserves in June and December of each year. In the second quarter of 2010, we recorded a \$2.9 million increase in self-insurance costs associated with professional and general liability risks due to revised actuarial estimates that primarily resulted from an increase in expected losses on a subset of claims in our recent claims history.

In addition, and as discussed above, the investments we are making in our core business in 2010, including the investment in our case management function, have increased *Other operating expenses* over the same periods of 2009. The timing of this initiative will continue to impact *Other operating expenses* in future quarters.

General and Administrative Expenses

General and administrative expenses primarily include administrative expenses such as information technology services, corporate accounting, human resources, internal audit and controls, and legal services that are managed from our corporate headquarters in Birmingham, Alabama. These expenses also include all stock-based compensation expenses.

The increase in *General and administrative expenses* during the three and six months ended June 30, 2010 compared to the same periods of 2009 primarily resulted from increased expenses associated with stock-based compensation. Since 2007, we have issued restricted stock awards with vesting requirements that included a service condition, market condition, performance condition, or a combination thereof. Due to the Company's recent operating performance, our non-cash expenses associated with these awards have increased in 2010.

Supplies

Supplies expense includes all costs associated with supplies used while providing patient care. These costs include pharmaceuticals, food, needles, bandages, and other similar items.

The decrease in *Supplies* expense as a percent of *Net operating revenues* in both the quarter and year-to-date periods was due to our supply chain efforts and our continual focus on monitoring and actively managing pharmaceutical costs, as well as our increasing revenue base.

Depreciation and Amortization

Depreciation and amortization increased in both the quarter and year-to-date periods primarily as a result of increased capital expenditures in 2009.

Occupancy costs include amounts paid for rent associated with leased hospitals and outpatient rehabilitation satellite clinics, including common area maintenance and similar charges. These costs did not change significantly in the periods presented.

Provision for Doubtful Accounts

As disclosed previously, we have experienced denials of certain diagnosis codes by Medicare contractors based on medical necessity. We appeal most of these denials and have experienced a strong success rate for claims that have completed the appeals process. While our success rate is a positive reflection of the medical necessity of the applicable patients, the appeal process can take in excess of one year, and we cannot provide assurance as to the ongoing and future success of our appeals. As such, we make provisions against these receivables in accordance with our accounting policy that necessarily considers the age of the receivables under appeal as part of our *Provision for doubtful accounts*.

Medicare contractors ceased these denials in the latter part of 2009, which has resulted in a decrease in our *Provision for doubtful accounts* as a percent of *Net operating revenues* in both the quarter and year-to-date periods, as we have collected payments for our successfully appealed claims while not adding additional denied claims to our outstanding receivables balance. In addition, we have enhanced the processes around the recovery and capture of Medicare-related bad debts. Subsequent recoveries are recorded via the *Provision for doubtful accounts*.

Certain Medicare contractors reinstated denials of certain diagnosis codes during the second quarter of 2010. We may experience volatility in our *Provision for doubtful accounts* as a percent of *Net operating revenues* as claims are denied and the related receivables age during the appeals process.

Loss on Disposal of Assets

The *Loss on disposal of assets* in each period presented primarily resulted from various equipment disposals throughout each period. For the three and six months ended June 30, 2009, it also included losses associated with 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, as well as the write-off of certain assets as we updated, or “refreshed” some of our hospitals. For additional information, see Note 5, *Fair Value Measurements*, to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Government, Class Action, and Related Settlements

Government, class action, and related settlements for the three and six months ended June 30, 2009 included a \$48.6 million and \$33.7 million, respectively, increase in the liability associated with our securities litigation (as discussed in Note 22, *Settlements*, to the consolidated financial statements accompanying the 2009 Form 10-K) based on the value of our common stock and the associated common stock warrants underlying this settlement. These shares of common stock and associated common stock warrants were issued on September 30, 2009. *Government, class action, and related settlements* for the three and six months ended June 30, 2009 also included a net loss (gain) of \$0.1 million and (\$0.9) million, respectively, associated with certain settlements and other matters discussed in Note 22, *Settlements*, and Note 23, *Contingencies and Other Commitments*, to the consolidated financial statements accompanying the 2009 Form 10-K.

Professional Fees—Accounting, Tax, and Legal

Professional fees – accounting, tax, and legal for the three and six months ended June 30, 2010 related primarily to legal and consulting fees for continued litigation and support matters arising from prior reporting and restatement issues.

As discussed in Note 23, *Contingencies and Other Commitments*, to the 2009 Form 10-K, in June 2009, a court ruled that Richard M. Scrushy, our former chairman and chief executive officer, committed fraud and breached his fiduciary duties during his time with HealthSouth. Based on this judgment, we have no obligation to indemnify

him for any litigation costs. Therefore, we reversed the remainder of an accrual for his legal fees during the second quarter of 2009, which resulted in a reduction in *Professional fees – accounting, tax, and legal* of \$6.5 million during the three and six months ended June 30, 2009. Excluding the reversal of these fees, *Professional fees – accounting, tax, and legal* for the three and six months ended June 30, 2009 related primarily to legal and consulting fees for continued litigation and support matters arising from prior reporting and restatement issues and income tax return and preparation and consulting fees for various tax projects related to our pursuit of our remaining income tax refund claims.

Interest Expense and Amortization of Debt Discounts and Fees

As discussed in Note 3, *Derivative Instruments*, to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report, we have effectively converted \$884.0 million of variable rate interest to a fixed rate via interest rate swaps that are not designated as hedges. Because these swaps are not designated as hedges, the line item *Interest expense and amortization of debt discounts and fees* benefits from lower interest rates. However, lower rates generate increased payments on our interest rate swaps and increase amounts included in the line item *Loss on interest rate swaps*.

The decrease in *Interest expense and amortization of debt discounts and fees* quarter over quarter was due to lower average borrowings which resulted from debt reductions throughout 2009. Our average interest rate in both quarters was 6.9%.

For the year-to-date periods, approximately \$2.9 million of the decrease in *Interest expense and amortization of debt discounts and fees* period over period was due to lower average borrowings which resulted from debt reductions throughout 2009. The remainder of the decrease was due to a decrease in our average interest rate. Our average interest rate was 6.9% during the six months ended June 30, 2010 compared to an average rate of 7.2% during the six months ended June 30, 2009.

See Note 8, *Long-term Debt*, to the consolidated financial statements accompanying the 2009 Form 10-K for additional information.

Other Income

Other income is primarily comprised of interest income and gains and losses on sales of investments. *Other income* for the three and six months ended June 30, 2009 included \$0.1 million and \$0.8 million, respectively, of impairment charges associated with our marketable equity securities (see Note 3, *Cash and Marketable Securities*, to the consolidated financial statements accompanying the 2009 Form 10-K).

(Gain) Loss on Interest Rate Swaps

Our *(Gain) loss on interest rate swaps* in each period represents amounts recorded related to the fair value adjustments and quarterly settlements recorded for our interest rate swaps that are not designated as hedges. The net (gain) or loss recorded in each period presented represents the change in the market's expectations for interest rates over the remaining term of the swap agreements. To the extent the expected LIBOR rates increase, we will record net gains. When expected LIBOR rates decrease, we will record net losses.

During the three months ended June 30, 2010 and 2009, we made net cash settlement payments of \$11.2 million and \$10.6 million, respectively, to our counterparties. During the six months ended June 30, 2010 and 2009, we made net cash settlement payments of \$23.1 million and \$19.1 million, respectively, to our counterparties. For additional information regarding these interest rate swaps, see Note 3, *Derivative Instruments*, to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Equity in Net (Income) Loss of Nonconsolidated Affiliates

As disclosed in Note 1, *Basis of Presentation*, of the notes to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report, *Equity in net loss of nonconsolidated affiliates* for the three and six months ended June 30, 2009 included an out-of-period adjustment associated with a facility we account for using the equity method of accounting. This adjustment created a charge of \$4.9 million and \$4.5 million for the three and six months ended June 30, 2009, respectively.

Income from Continuing Operations Before Income Tax (Benefit) Expense

The increase in *Income from continuing operations before income tax (benefit) expense* (“pre-tax income”) during both the quarter and year-to-date periods resulted from increased *Net operating revenues* and effective expense management. Pre-tax income for the three and six months ended June 30, 2009 included net losses of \$48.7 million and \$32.8 million, respectively, associated with *Government, class action, and related settlements* .

See also Note 9, *Condensed Consolidating Financial Information* , to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)* , of this report for condensed consolidating financial information 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.”

Provision for Income Tax (Benefit) Expense

Our *Provision for income tax benefit* of \$2.2 million for the three months ended June 30, 2010 included 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 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 included 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 other comprehensive income items and increases in basis differences of certain indefinite-lived assets.

Our *Provision for income tax benefit* of \$0.3 million for the three months ended June 30, 2009 included (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 included (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.

Net Income Attributable to Noncontrolling Interests

Net income attributable to noncontrolling interests represents the share of net income or loss allocated to members or partners in our consolidated affiliates. Fluctuations in these amounts are primarily driven by the financial performance of the applicable hospital population each period.

Results of Discontinued Operations

The operating results of discontinued operations are as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
HealthSouth Corporation:				
Net operating revenues	\$ 0.2	\$ 2.2	\$ 0.9	\$ 5.1
Costs and expenses	0.6	3.1	1.8	7.6
Impairments	-	-	0.6	-
Loss from discontinued operations	(0.4)	(0.9)	(1.5)	(2.5)
Loss on disposal of assets of discontinued operations	-	(0.3)	(0.9)	(0.4)
Income tax benefit	-	-	0.2	0.1
Loss from discontinued operations, net of tax	<u>\$ (0.4)</u>	<u>\$ (1.2)</u>	<u>\$ (2.2)</u>	<u>\$ (2.8)</u>
Other:				
Net operating revenues	\$ 0.4	\$ 2.5	\$ 0.6	\$ 5.0
Costs and expenses	(0.4)	-	1.1	3.6
Impairments	-	-	-	-
Income (loss) from discontinued operations	0.8	2.5	(0.5)	1.4
(Loss) gain on disposal of assets of discontinued operations	(0.3)	0.1	(0.3)	0.1
Income tax expense	-	(0.1)	-	(0.1)
Income (loss) from discontinued operations, net of tax	<u>\$ 0.5</u>	<u>\$ 2.5</u>	<u>\$ (0.8)</u>	<u>\$ 1.4</u>
Total:				
Net operating revenues	\$ 0.6	\$ 4.7	\$ 1.5	\$ 10.1
Costs and expenses	0.2	3.1	2.9	11.2
Impairments	-	-	0.6	-
Income (loss) from discontinued operations	0.4	1.6	(2.0)	(1.1)
Loss on disposal of assets of discontinued operations	(0.3)	(0.2)	(1.2)	(0.3)
Income tax (expense) benefit	-	(0.1)	0.2	-
Income (loss) from discontinued operations, net of tax	<u>\$ 0.1</u>	<u>\$ 1.3</u>	<u>\$ (3.0)</u>	<u>\$ (1.4)</u>

HealthSouth Corporation . Our results of discontinued operations primarily included the operations of the Dallas Medical Center (closed in October 2008) and our hospital in Baton Rouge, Louisiana (sold in January 2010). During the first quarter of 2010, we recorded an impairment charge of \$0.6 million related to the Dallas Medical Center. We determined the fair value of the impaired long-lived assets at this closed facility primarily based on the assets' estimated fair value using valuation techniques that included third-party appraisals.

Other . Results of discontinued operations in "other" primarily include the results of operations of our former surgery centers, outpatient, and diagnostic divisions. See Note 18, *Assets Held for Sale and Results of Discontinued Operations* , to the consolidated financial statements accompanying the 2009 Form 10-K for additional information.

Liquidity and Capital Resources

Our primary sources of liquidity are cash on hand, cash flows from operations, and borrowings under our revolving credit facility. As of June 30, 2010, we had \$172.6 million in *Cash and cash equivalents* . This amount excludes \$49.7 million in *Restricted cash* and \$25.0 million of restricted marketable securities (\$1.0 million included in *Other current assets* and \$24.0 million included in *Other long-term assets* in our condensed consolidated balance sheet accompanying this report). Our restricted assets pertain primarily to obligations associated with our captive insurance company, as well as obligations we have under agreements with external partners. *Cash and cash equivalents* increased during the first six months of 2010 primarily due to strong operational cash flows as a result of increased *Net operating revenues* , as discussed above, and effective expense management. In addition, we negotiated with certain of our external partners to release restrictions placed on the joint venture's cash which allowed us to manage and control the use of the joint venture's cash (see Note 3, *Cash and Marketable Securities* , to the financial statements accompanying the 2009 Form 10-K).

As of June 30, 2010, we had all \$400 million available to us under our revolving credit facility. We monitor the financial strength of our depositories, creditors, insurance carriers, and other counterparties using publicly available information, as well as qualitative inputs. 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 draws under our revolving credit facility, if needed. However, no such assurances can be provided.

We have scheduled principal payments of \$10.8 million and \$21.2 million in the remainder of 2010 and 2011, respectively, related to long-term debt obligations. We do not face near-term refinancing risk, as our revolving credit facility does not expire until 2012, a portion of our term loan facility does not mature until 2013, with the remainder maturing in 2015, and the majority of our bonds are not due until 2016 and 2020.

Our credit agreement governs the vast majority of our senior secured borrowings and contains financial covenants that include a leverage ratio and an interest coverage ratio. As of June 30, 2010, we were in compliance with the covenants under our credit agreement.

See Item 1A, *Risk Factors*, and Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying the 2009 Form 10-K for a discussion of risks and uncertainties facing us.

Sources and Uses of Cash

As noted above, our primary sources of liquidity are cash on hand, cash flows from operations, and borrowings under our revolving credit facility. The following table shows the cash flows provided by or used in operating, investing, and financing activities for the six months ended June 30, 2010 and 2009 (in millions):

	Six Months Ended June 30,	
	2010	2009
Net cash provided by operating activities	\$ 172.7	\$ 229.2
Net cash used in investing activities	(39.7)	(77.8)
Net cash used in financing activities	(41.4)	(133.8)
Increase in cash and cash equivalents	<u>\$ 91.6</u>	<u>\$ 17.6</u>

Operating activities. *Net cash provided by operating activities* for the six months ended June 30, 2010 included \$9.7 million of state income tax refunds associated with prior periods. *Net cash provided by operating activities* for the six months ended June 30, 2009 included \$73.8 million in net cash proceeds related to the UBS Settlement and the receipt of \$54.0 million of federal and state income tax refunds related to prior periods. See Note 19, *Income Taxes*, and Note 22, *Settlements*, to the consolidated financial statements accompanying the 2009 Form 10-K for additional information. Excluding these amounts, *Net cash provided by operating activities* increased period over period due to the increase in *Net operating revenues* and effective expense management, as discussed above. In addition, the timing of payroll - and interest-related payments positively impacted the period-over-period variance.

Investing activities. *Net cash used in investing activities* decreased period over period due to a reduction in restricted cash, as discussed above, and the receipt of proceeds from the sale of our hospital in Baton Rouge, Louisiana in January 2010.

Financing activities. *Net cash used in financing activities* decreased period over period due to a reduction in net debt payments. Net debt payments were \$11.0 million during the six months ended June 30, 2010 and resulted from scheduled principal payments on long-term debt. Net debt payments were \$107.5 million during the six months ended June 30, 2009. See Note 8, *Long-term Debt*, to the consolidated financial statements accompanying the 2009 Form 10-K for additional information related to the 2009 net debt payments.

Adjusted Consolidated EBITDA

Management believes Adjusted Consolidated EBITDA as defined in our credit agreement is a measure of our ability to service our debt and our ability to make capital expenditures.

We use Adjusted Consolidated EBITDA on a consolidated basis as a liquidity measure. We believe this financial measure on a consolidated basis is important in analyzing our liquidity because it is the key component of certain material covenants contained within our credit agreement, which is discussed in more detail in Note 8, *Long-term Debt*, to the consolidated financial statements accompanying the 2009 Form 10-K. These covenants are material terms of the credit agreement, and the credit agreement represents a substantial portion of our capitalization. Non-compliance with these financial covenants under our credit agreement—our interest coverage ratio and our leverage ratio—could result in our lenders requiring us to immediately repay all amounts borrowed. 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 favorable to those in our existing credit agreement. In addition, if we cannot satisfy these financial covenants, we would be prohibited under our credit agreement from engaging in certain activities, such as incurring additional indebtedness, making certain payments, and acquiring and disposing of assets. Consequently, Adjusted Consolidated EBITDA is critical to our assessment of our liquidity.

In general terms, the definition of Adjusted Consolidated EBITDA, per our credit agreement, allows us to add back to or subtract from consolidated *Net income* unusual non-cash or non-recurring items. These items include, but may not be limited to, (1) amounts associated with government, class action, and related settlements, (2) amounts related to discontinued operations and closed locations, (3) charges in respect of professional fees for reconstruction and restatement of financial statements, including fees paid to outside professional firms for matters related to internal controls and legal fees for continued litigation and support matters discussed in Note 22, *Settlements*, and Note 23, *Contingencies and Other Commitments*, to the consolidated financial statements accompanying the 2009 Form 10-K and Note 8, *Contingencies*, to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report, (4) stock-based compensation expense, (5) net investment and other income (including interest income), and (6) fees associated with our divestiture activities. We reconcile Adjusted Consolidated EBITDA to *Net income* and to *Net cash provided by operating activities*.

In accordance with the credit agreement, the Company is allowed to add certain other items to the calculation of Adjusted Consolidated EBITDA, and there may also be certain other deductions required. This includes the interest income associated with income tax recoveries, as discussed in Note 19, *Income Taxes*, to the consolidated financial statements included in the 2009 Form 10-K. In addition, we are allowed to add non-recurring cash gains, such as the cash proceeds from the UBS Settlement (see Note 22, *Settlements*, to the consolidated financial statements included in the 2009 Form 10-K) to the calculation of Adjusted Consolidated EBITDA. As these adjustments may not be indicative of the Company's ongoing performance, they have been excluded from Adjusted Consolidated EBITDA presented herein.

However, Adjusted Consolidated EBITDA is not a measure of financial performance under generally accepted accounting principles in the United States of America, and the items excluded from Adjusted Consolidated EBITDA are significant components in understanding and assessing financial performance. Therefore, Adjusted Consolidated EBITDA should not be considered a substitute for *Net income* or cash flows from operating, investing, or financing activities. Because Adjusted Consolidated EBITDA is not a measurement determined in accordance with GAAP and is thus susceptible to varying calculations, Adjusted Consolidated EBITDA, as presented, may not be comparable to other similarly titled measures of other companies. Revenues and expenses are measured in accordance with the policies and procedures described in Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying the 2009 Form 10-K.

Our Adjusted Consolidated EBITDA for the three months and six months ended June 30, 2010 and 2009 was as follows (in millions):

Reconciliation of Net Income to Adjusted Consolidated EBITDA

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income	\$ 57.5	\$ 3.6	\$ 108.0	\$ 57.1
(Income) loss from discontinued operations, net of tax, attributable to HealthSouth	(0.1)	(1.1)	3.0	1.9
Provision for income tax (benefit) expense	(2.2)	(0.3)	0.3	0.9
(Gain) loss on interest rate swaps	(0.3)	3.8	4.0	8.8
Interest expense and amortization of debt discounts and fees	30.1	31.1	60.6	65.5
Loss (gain) on early extinguishment of debt	0.1	(1.3)	0.4	(3.1)
Professional fees—accounting, tax, and legal	5.7	(3.3)	8.6	1.5
Government, class action, and related settlements	-	48.7	-	32.8
Net noncash loss on disposal of assets	0.4	1.3	0.4	2.3
Depreciation and amortization	18.7	17.6	37.0	35.0
Impairment charges, including investments	-	0.1	-	0.8
Stock-based compensation expense	4.0	2.9	7.8	6.6
Net income attributable to noncontrolling interests	(10.2)	(9.1)	(20.0)	(17.7)
Adjusted Consolidated EBITDA	<u>\$ 103.7</u>	<u>\$ 94.0</u>	<u>\$ 210.1</u>	<u>\$ 192.4</u>

Reconciliation of Adjusted Consolidated EBITDA to Net Cash Provided by Operating Activities

	Six Months Ended June 30,	
	2010	2009
Adjusted Consolidated EBITDA	\$ 210.1	\$ 192.4
Provision for doubtful accounts	12.8	17.5
Professional fees—accounting, tax, and legal	(8.6)	(1.5)
Interest expense and amortization of debt discounts and fees	(60.6)	(65.5)
UBS Settlement proceeds, gross	-	100.0
Equity in net (income) loss of nonconsolidated affiliates	(5.2)	0.2
Net income attributable to noncontrolling interests in continuing operations	20.0	17.2
Amortization of debt discounts and fees	3.4	3.2
Distributions from nonconsolidated affiliates	3.3	3.9
Current portion of income tax benefit	1.8	1.0
Change in assets and liabilities	2.2	(23.4)
Change in government, class action, and related settlements	(0.8)	(8.7)
Other operating cash used in discontinued operations	(4.2)	(7.0)
Other	(1.5)	(0.1)
Net cash provided by operating activities	<u>\$ 172.7</u>	<u>\$ 229.2</u>

The increase in Adjusted Consolidated EBITDA was due primarily to the increase in *Net operating revenues* discussed above, as well as effective expense management.

Funding Commitments

We have scheduled principal payments of \$10.8 million and \$21.2 million in the remainder of 2010 and 2011, respectively, related to long-term debt obligations. For additional information about our long-term debt obligations, see Note 8, *Long-term Debt*, to the consolidated financial statements accompanying the 2009 Form 10-K.

Our capital expenditures include costs associated with our hospital refresh program, capacity expansions, de-novo projects, IT initiatives, and building and equipment upgrades and purchases. During the six months ended June 30, 2010, we made capital expenditures of \$29.9 million. This excludes \$9.9 million paid to acquire an inpatient rehabilitation hospital in June 2010, as discussed above. During 2010, we expect to spend approximately \$110 million for capital expenditures. Approximately \$60 million of this budgeted amount is considered discretionary. Actual amounts spent will be dependent upon our continued strong cash flows from operations, the timing of development projects, and any development opportunities that may present themselves.

For a discussion of risk factors related to our business and our industry, see Item 1A, *Risk Factors*, of the 2009 Form 10-K and Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying the 2009 Form 10-K.

Off-Balance Sheet Arrangements

Other than the guarantees discussed below and in Note 4, *Guarantees*, to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report, there have been no material changes to the off-balance sheet arrangements described in Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, of the 2009 Form 10-K.

We are secondarily liable for certain lease obligations primarily associated with sold facilities, including the sale of our surgery centers, outpatient, and diagnostic divisions during 2007. As of June 30, 2010, we were secondarily liable for 58 such guarantees. The remaining terms of these guarantees range 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 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. For additional information regarding these guarantees, see Note 4, *Guarantees*, to the condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

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.

Critical Accounting Policies

Our significant accounting policies are discussed in Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying the 2009 Form 10-K. Of those significant accounting policies, those that we consider to be the most critical to aid in fully understanding and evaluating our reported financial results, as they require management's most difficult, subjective, or complex judgments, resulting from the need to make estimates about the effect of matters that are inherently uncertain, are disclosed in Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, "Critical Accounting Policies," to the 2009 Form 10-K.

Since the filing of the 2009 Form 10-K, there have been no material changes to our critical accounting policies.

Recent Accounting Pronouncements

For information regarding recent accounting pronouncements, see Note 1, *Basis of Presentation*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out by our management, including our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended. Based on our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There have been no changes in our Internal Control over Financial Reporting during the quarter ended June 30, 2010 that have a material effect on our Internal Control over Financial Reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information relating to certain legal proceedings in which we are involved is included in Note 8, *Contingencies*, to the condensed consolidated financial statements contained in Part I, Item 1, *Financial Statements (Unaudited)*, of this report and is incorporated herein by reference and should be read in conjunction with the related disclosure previously reported in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 and our Annual Report on Form 10-K for the year ended December 31, 2009 (the “2009 Form 10-K”).

On December 30, 2004, we entered into a corporate integrity agreement (the “CIA”) with the Office of Inspector General of the United States Department of Health and Human Services (the “HHS-OIG”). This CIA had an effective date of January 1, 2005 and a term of five years from that effective date. On April 29, 2010, we submitted the final annual report required by the CIA, which included a report by our independent review organization, to the HHS-OIG detailing our performance of the requirements of the CIA in 2009. On May 10, 2010, we received notice from the HHS-OIG that we completed our requirements under the CIA and accordingly, the CIA is now terminated. For further discussion of the CIA and our obligations under it, see Note 22, *Settlements*, “Medicare Program Settlement—The December 2004 Corporate Integrity Agreement,” to the consolidated financial statements accompanying the 2009 Form 10-K.

Item 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Part I, Item 1A, *Risk Factors*, of the 2009 Form 10-K. Certain information in those risk factors has been updated by the discussion in the “Executive Overview – Key Challenges” section of Part I, Item 2, *Management’s Discussion and Analysis of Financial Condition and Results of Operations*, of this report, which section is incorporated by reference herein.

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

The following table summarizes our repurchases of equity securities during the three months ended June 30, 2010:

Period	Total Number of Shares (or Units) Purchased ⁽¹⁾	Average Price Paid per Share (or Unit) (\$)	Total Number of Shares (or Units) Purchased as part of Publicly Announced Plans or Programs	Maximum Number of Shares (or Units) That May yet Be Purchased Under the Plans or Program
April 1 through April 30, 2010	-	\$ -	-	-
May 1 through May 31, 2010	978	19.48	-	-
June 1 through June 30, 2010	-	-	-	-
Total	<u>978</u>	<u>19.48</u>	<u>-</u>	<u>-</u>

⁽¹⁾ Shares in this column were tendered by employees as payment of tax liability incident to the vesting of previously awarded shares of restricted stock.

Item 6. Exhibits

The exhibits required by Regulation S-K are set forth in the following list and are filed by attachment to this report unless otherwise noted.

No.	Description
3.1	Restated Certificate of Incorporation of HealthSouth Corporation, as filed in the Office of the Secretary of State of the State of Delaware on May 21, 1998 (incorporated by reference to HealthSouth's Annual Report on Form 10-K filed with the SEC on June 27, 2005).
3.2	Certificate of Amendment to the Restated Certificate of Incorporation of HealthSouth Corporation, as filed in the Office of the Secretary of State of the State of Delaware on October 25, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed on October 31, 2006).
3.3	Amended and Restated Bylaws of HealthSouth Corporation, effective as of October 30, 2009, (incorporated by reference to Exhibit 3.3 to HealthSouth's Quarterly Report on Form 10-Q filed on November 4, 2009).
3.4	Certificate of Designations of 6.50% Series A Convertible Perpetual Preferred Stock, as filed with the Secretary of State of the State of Delaware on March 7, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed on March 9, 2006).
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Sections of the HealthSouth Corporation Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, formatted in XBRL (eXtensible Business Reporting Language), submitted in the following files:
	101.INS XBRL Instance Document
	101.SCHXBRL Taxonomy Extension Schema Document
	101.CALXBRL Taxonomy Extension Calculation Linkbase Document
	101.DEF XBRL Taxonomy Extension Definition Linkbase Document
	101.LABXBRL Taxonomy Extension Label Linkbase Document
	101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURE

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

HEALTHSOUTH Corporation

By: /s/ DOUGLAS E. COLTHARP

Name: Douglas E. Coltharp

Title: Executive Vice President and Chief Financial Officer

Date: August 5, 2010

EXHIBIT INDEX

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**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Jay Grinney, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HealthSouth Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2010

By: /s/ JAY GRINNEY
Name: Jay Grinney
Title: President and Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Douglas E. Coltharp, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HealthSouth Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2010

By: /s/ D OUGLAS E. C OLTHARP
Name: Douglas E. Coltharp
Title: Executive Vice President and Chief Financial
Officer

**CERTIFICATE OF CHIEF EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of HealthSouth Corporation on Form 10-Q for the period ended June 30, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jay Grinney, President and Chief Executive Officer of HealthSouth Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge and belief:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of HealthSouth Corporation.

Date: August 5, 2010

By: /s/ JAY GRINNEY
Name: Jay Grinney
Title: President and Chief Executive Officer

A signed original of this written statement has been provided to HealthSouth Corporation and will be retained by HealthSouth Corporation and furnished to the Securities and Exchange Commission or its staff upon request. This written statement shall not, except to the extent required by the 2002 Act, be deemed filed by HealthSouth Corporation for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that HealthSouth Corporation specifically incorporates it by reference.

**CERTIFICATE OF CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of HealthSouth Corporation on Form 10-Q for the period ended June 30, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Douglas E. Coltharp, Executive Vice President and Chief Financial Officer of HealthSouth Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge and belief:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of HealthSouth Corporation.

Date: August 5, 2010

By: /s/ D OUGLAS E. C OLTHARP
Name: Douglas E. Coltharp
Title: Executive Vice President and Chief Financial
Officer

A signed original of this written statement has been provided to HealthSouth Corporation and will be retained by HealthSouth Corporation and furnished to the Securities and Exchange Commission or its staff upon request. This written statement shall not, except to the extent required by the 2002 Act, be deemed filed by HealthSouth Corporation for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that HealthSouth Corporation specifically incorporates it by reference.