NOGLOWS WILLIAM P
Form 4
December 02, 2009

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

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(Print or Type Responses)

1. Name and Address of Reporting Person *
NOGLOWS WILLIAM P

(Last) (First) (Middle)

C/O CABOT MICROELECTRONICS CORPORATION, 870 COMMONS DRIVE

(Street)

AURORA, IL 60504

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
CABOT MICROELECTRONICS CORP [CCMP]

3. Date of Earliest Transaction (Month/Day/Year)
12/01/2009

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Chairman, President & CEO

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	12/01/2009		F (1)		1,414	D	$ 31.11	88,674.029	D	
Common Stock	12/01/2009		F (1)		1,988	D	$ 31.11	86,686.029	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

number.

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
NOGLOWS WILLIAM P C/O CABOT MICROELECTRONICS CORPORATION 870 COMMONS DRIVE AURORA, IL 60504	X		Chairman, President & CEO	

Signatures

/s/ H. Carol Bernstein (Power of Attorney)	12/02/2009
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Withheld to cover for tax purposes as per terms of Equity Incentive Plan.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ew Roman', Times">Six Months Ended June 30, 2008 and June 30, 2009

The following table summarizes the statement of cash flows for the six months ended June 30, 2008 and 2009:

	Six Months Ended June 30,	
	2008	**2009**

	(in thousands)	
Cash flows provided by (used in) operating activities	$ (993)	$ 57,235
Cash flows used in investing activities	(30,353)	(19,640)
Cash flows provided by (used in) financing activities	34,351	(74,166)
Net increase (decrease) in cash and cash equivalents	3,005	(36,571)
Cash and cash equivalents at beginning of period	4,529	64,260
Cash and cash equivalents at end of period	$ 7,534	$ 27,689

Operating activities provided $57.2 million and used $1.0 million of cash flow for the six months ended June 30, 2009 and June 30, 2008, respectively. The principal reason for the increase in our operating cash flow was the increase in our net income, a smaller increase in our accounts receivable and the use of Federal net operating losses to minimize our tax payments. Our days sales outstanding were 55 days at June 30, 2009 compared to 53 days at December 31, 2008. Our days sales outstanding were 57 days at June 30, 2008 compared to 48 days at December 31, 2007. These increases in days sales outstanding were primarily related to the timing of the receipt of the periodic interim payments from Medicare for the services provided at our specialty hospitals and a shortfall in payments due to Medicare s periodic interim payment methodology.

Investing activities used $19.6 million of cash flow for the six months ended June 30, 2009. We used $21.0 million of cash for the purchase of property and equipment which was offset by $1.3 million of proceeds from the sale of property. Investing activities used $30.4 million of cash flow for the six months ended June 30, 2008. The primary use of cash in the six months ended June 30, 2008 was $26.1 million related to the purchase of property and equipment and $4.2 million related to the acquisition of minority interests and the final settlement of the purchase price for the acquisition of the outpatient rehabilitation division of HealthSouth Corporation.

Financing activities used $74.2 million of cash flow for the six months ended June 30, 2009. The primary use of cash related to the repurchase of Select s 75/8% senior subordinated notes for $30.1 million, repayment of bank overdrafts of $4.7 million, net payments on our senior secured credit facility of $38.4 million and $1.8 million in distributions to

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non-controlling interests. These payments were offset by net borrowings related to seller and other debt of $1.3 million. Financing activities provided $34.4 million of cash flow for the six months ended June 30, 2008. The primary source of cash related to borrowings, net of repayments, on our senior secured credit facility of $45.4 million, offset by repayment of bank overdrafts of $6.9 million, principal payments on seller and other debt of $2.6 million, repurchase of common and preferred stock of $0.6 million and distributions to minority interests of $1.0 million. The net borrowings on our senior secured credit facility for the six months ended June 30, 2008 were used to fund the slow-down we experienced in our collection of accounts receivable and our purchase of property and equipment.

Year Ended December 31, 2008, Year Ended December 31, 2007 and the Year Ended December 31, 2006

The following table summarizes the statement of cash flows for the years ended December 31, 2008, 2007 and 2006:

	Year Ended December 31,		
	2006	2007	2008
	(in thousands)		
Cash flows provided by operating activities	$ 227,651	$ 86,013	$ 107,438
Cash flows used in investing activities	(81,481)	(382,676)	(60,438)
Cash flows provided by (used in) financing activities	(100,466)	219,592	12,731
Effect of exchange rate changes on cash and cash equivalents	35		
Net increase (decrease) in cash and cash equivalents	45,739	(77,071)	59,731
Cash and cash equivalents at beginning of period	35,861	81,600	4,529
Cash and cash equivalents at end of period	$ 81,600	$ 4,529	$ 64,260

Operating activities generated $107.4 million in cash during the year ended December 31, 2008. The increase in cash flow provided by operating activities in comparison to our operating cash flow provided by operating activities for the year ended December 31, 2007 is principally related to a reduction in the cash taxes we paid during 2008. Our days sales outstanding were 53 days at December 31, 2008 compared to 48 days at December 31, 2007. The increase in days sales outstanding between December 31, 2007 and December 31, 2008 is primarily related to the timing of the receipt of the periodic interim payments from Medicare for the services provided at our specialty hospitals and a shortfall in payments due to Medicare s periodic interim payment methodology.

Operating activities generated $86.0 million in cash during the year ended December 31, 2007. Our days sales outstanding were 48 days at December 31, 2007 compared to 41 days at December 31, 2006. In comparison to our operating cash flow generated for the year ended December 31, 2006, our operating cash flow was negatively affected by a reduction in our operating earnings, an increase in interest expense and an increase in our accounts receivable.

Operating activities generated $227.7 million in cash during the year ended December 31, 2006. Our operating cash flow was positively affected by a reduction in our accounts receivable and tax benefits we realized by changing our tax accounting method used for deducting bad debts. The tax accounting change had the effect of accelerating the tax deduction for bad debt reserves. Our days sales outstanding were 41 days at December 31, 2006 compared to 52 days at December 31, 2005. The significant reduction in days sales outstanding was the result of several factors. The timing of our periodic interim payments from Medicare received by our specialty hospitals resulted in a seven day decline in the days sales outstanding. The remaining decline was the result of improved cash collections.

Investing activities used $60.4 million, $382.7 million, and $81.5 million of cash flow for the years ended December 31, 2008, 2007, and 2006, respectively. Of this amount, we incurred acquisition related payments of $7.6 million, $237.0 million, and $3.4 million, respectively in 2008, 2007, and 2006. In 2007, the acquisition of the outpatient division of HealthSouth Corporation accounted for the $236.9 million in acquisition payments. The remaining acquisition payments relate primarily to small acquisitions of outpatient businesses. Investing activities also used cash for the purchases of property and equipment of $56.5 million, $166.1 million, and $155.1 million in 2008, 2007, and 2006, respectively. In 2008 our purchases of property and equipment were principally related to routine capital expenditures. In 2007 and 2006 our purchases of property and equipment were related principally to construction of new hospitals and relocation of existing hospitals. Additionally during 2006 and 2007 we made

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major improvements and expanded our rehabilitation hospital in West Orange, New Jersey. We sold business units and real property which generated $3.4 million and $16.0 million in cash during the year ended December 31, 2008 and 2007, respectively. During 2006, we sold all of our Canadian operations and a group of outpatient rehabilitation clinics. The cash flow from these transactions, net of operating cash transferred with the businesses, was $75.0 million.

Financing activities provided $12.7 million of cash for the year ended December 31, 2008. The cash resulted primarily from borrowings on our senior secured credit facility of $23.2 million, offset by payments on seller and other debt of $5.6 million, distributions to non-controlling interests of $2.0 million, payment of initial public offering costs of $1.3 million and repurchase of Select s 75/8% senior subordinated notes of $1.0 million.

Financing activities provided $219.6 million of cash for the year ended December 31, 2007. The cash resulted primarily from borrowings, net of repayments on our senior secured credit facility of $213.5 million and proceeds from bank overdrafts of $8.9 million. Approximately $203.0 million of the borrowings from our senior secured credit facility were used to fund the acquisition of the outpatient division of HealthSouth Corporation. The remaining borrowings were used to fund our normal operations including our hospital construction activities.

Financing activities used $100.5 million of cash for the year ended December 31, 2006. The cash usage resulted primarily from repayments, net of borrowings, on our senior secured credit facility of $90.8 million and repayment of bank overdrafts of $7.1 million.

Capital Resources

We had net working capital of $103.8 million at June 30, 2009 compared to net working capital of $118.4 million at December 31, 2008.

On March 19, 2007, we entered into Amendment No. 2, and on March 28, 2007, we entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 increased the general exception to the prohibition on asset sales under our senior secured credit facility from $100.0 million to $200.0 million, relaxed certain financial covenants starting March 31, 2007 and waived Select s requirement to prepay certain term loan borrowings following the year ended December 31, 2006. The Incremental Facility Amendment provided to our company an incremental term loan of $100.0 million, the proceeds of which we used to pay a portion of the purchase price for the HealthSouth transaction.

On August 5, 2009, we entered into Amendment No. 3 to our senior secured credit facility with a group of holders of Tranche B term loans and JPMorgan Chase Bank, N.A., as administrative agent. Amendment No. 3 extended the maturity of $384.5 million principal amount of Tranche B term loans from February 24, 2012 to August 22, 2014 and made related technical changes to the senior secured credit facility. Holders of Tranche B term loans that extended the maturity of their Tranche B term loans now hold Tranche B-1 term loans that mature on August 22, 2014, and holders of Tranche B term loans that did not extend the maturity of their Tranche B term loans continue to hold Tranche B term loans that mature on February 24, 2012. The applicable rate for the Tranche B-1 term loans under our senior secured credit facility has increased to 3.75% for adjusted LIBOR loans and 2.75% for alternate base rate loans. We may apply future voluntary prepayments entirely to Tranche B term loans or pro rata between Tranche B term loans and Tranche B-1 term loans. Under the terms of Amendment No. 3, if, prior to August 5, 2011, our senior secured credit facility is amended to reduce the applicable rate for Tranche B-1 term loans, then we will be required to pay a fee in an amount equal to 1% of the outstanding Tranche B-1 term loans held by those holders of Tranche B-1 term loans that agree to amend our senior secured credit facility to reduce the applicable rate. In addition, if, prior to August 5, 2011, we make any prepayment of Tranche B-1 term loans with proceeds of any term loan indebtedness, we will be required to pay a fee to holders of Tranche B-1 term loans in an amount equal to 1% of the outstanding

Tranche B-1 term loans that are being prepaid.

After giving effect to the Incremental Facility Amendment and Amendment No. 3, our senior secured credit facility provides for senior secured financing consisting of:

a $300.0 million revolving loan facility that will terminate on February 24, 2011, including both a letter of credit sub-facility and a swingline loan sub-facility,

$268.6 million in Tranche B term loans that mature on February 24, 2012, and

$384.5 million in Tranche B-1 term loans that mature on August 22, 2014.

The interest rates per annum applicable to loans, other than swingline loans and Tranche B-1 term loans, under our senior secured credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The interest rates per annum applicable to Tranche B-1 term loans under our senior credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The alternate base rate is the greater of (1) JPMorgan Chase Bank, N.A. s prime rate and (2) one-half of 1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate is determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The applicable margin percentage for borrowings under our revolving loans is subject to change based upon the ratio of Select s total indebtedness to consolidated EBITDA (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 1.50% for alternate base rate loans and (2) 2.50% for adjusted LIBOR loans. The applicable margin percentages for Tranche B term loans are (1) 1.00% for alternate base rate loans and (2) 2.00% for adjusted LIBOR loans. The applicable margin percentages for Tranche B-1 term loans are (1) 2.75% for alternate base rate loans and (2) 3.75% for adjusted LIBOR loans.

Our senior secured credit facility requires Select to maintain certain interest expense coverage ratios and leverage ratios which become more restrictive over time. For the four consecutive fiscal quarters ended June 30, 2009, Select was required to maintain an interest expense coverage ratio (its ratio of consolidated EBITDA (as defined in our senior secured credit facility) to cash interest expense) for the prior four consecutive fiscal quarters of at least 1.75 to 1.00. As of June 30, 2009, Select was required to maintain its leverage ratio (its ratio of total indebtedness to consolidated EBITDA for the prior four consecutive fiscal quarters) at less than 5.25 to 1.00. On a pro forma as adjusted basis giving effect to this offering and the use of proceeds therefrom, for the four quarters ended June 30, 2009, Select s interest expense coverage ratio was 2.42 to 1.00 and Select s leverage ratio was 3.68 to 1.00 based upon the initial public offering price of $10.00 per share. Select s actual interest expense coverage ratio was 2.25 to 1.00 for the four quarters ended June 30, 2009, and Select s actual leverage ratio was 4.56 to 1.00 as of June 30, 2009.

Also, as of June 30, 2009, Select had $154.3 million of availability under our revolving loan facility (after giving effect to $30.7 million of outstanding letters of credit). On a pro forma as adjusted basis giving effect to this offering and the use of proceeds therefrom, as of June 30, 2009, we had $269.3 million of revolving loan availability under our senior secured credit facility (after giving effect to $30.7 million of outstanding letters of credit) based upon the initial public offering price of $10.00 per share.

On June 13, 2005, Select entered into a five year interest rate swap transaction with an effective date of August 22, 2005. On March 8, 2007 and November 23, 2007, Select entered into two additional interest rate swap transactions for three years with effective dates of May 22, 2007 and November 23, 2007, respectively. The swaps are designated as a cash flow hedge of forecasted LIBOR-based variable rate interest payments. The underlying variable rate debt is $500.0 million.

On February 24, 2005, EGL Acquisition Corp. issued and sold $660.0 million in aggregate principal amount of 75/8% senior subordinated notes due 2015, which Select assumed in connection with the Merger. The net proceeds of the offering were used to finance a portion of the funds needed to consummate the Merger with EGL Acquisition

Corp. The notes were issued under an indenture between EGL Acquisition Corp. and U.S. Bank Trust National Association, as trustee. Interest on the notes is payable semi-annually in arrears on February 1 and August 1 of each year. The notes are guaranteed by all of Select s wholly-owned subsidiaries, subject to certain exceptions. On or after February 1, 2010, the notes may be redeemed at Select s option, in whole or in part, at redemption prices that decline annually to 100% on and after February 1, 2013, plus accrued and unpaid interest. Upon a change of control of Holdings, each holder of notes may require us to repurchase all or any portion of the holder s notes at a purchase price equal to 101% of the principal amount plus accrued and unpaid interest to the date of purchase.

In December 2008, we paid approximately $1.0 million to repurchase and retire a portion of Select s 75/8% senior subordinated notes. The notes had a carrying value of $2.0 million. A gain on early retirement of debt in the amount of $0.9 million was recognized on the transaction which was net of the write-off of the unamortized deferred financing costs related to the debt. During the six months ended June 30, 2009, we paid approximately $30.1 million to repurchase and retire additional 75/8% senior subordinated notes. These notes had a carrying value of $46.5 million. A gain on early retirement of debt in the amount of $15.3 million was recognized, which was net of the write-off of unamortized deferred financing costs related to the debt.

On September 29, 2005, we sold $175.0 million of senior floating rate notes due 2015, which bear interest at a rate per annum, reset semi-annually, equal to the 6-month LIBOR plus 5.75%. Interest is payable semi-annually in arrears on March 15 and September 15 of each year, with the principal due in full on September 15, 2015. The senior floating rate notes are general unsecured obligations of ours and are not guaranteed by Select or any of its subsidiaries. In connection with the issuance of the senior floating rate notes, Select entered into two interest rate swap transactions. The notional amount of the interest rate swaps is $175.0 million. The variable interest rate of the debt was 7.7% and the fixed rate after the swaps was 10.2% at June 30, 2009. The net proceeds of the issuance of the senior floating rate notes, together with cash was used to reduce the amount of our preferred stock, to make a payment to participants in our long-term incentive plan and to pay related fees and expenses. In August 2009, we paid approximately $6.5 million to repurchase and retire senior floating rate notes with a carrying value of $7.7 million.

We may from time to time seek to retire or purchase our outstanding debt through cash purchases and/or exchanges for equity securities, in open market purchases, privately negotiated transactions or otherwise. Such repurchases or exchanges, if any, may be funded from operating cash flows or other sources and will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.

We believe our internally generated cash flows and borrowing capacity under our senior secured credit facility will be sufficient to finance operations for the foreseeable future. Our lenders, including the lenders participating in our senior secured credit facility, may have suffered losses related to their lending and other financial relationships, especially because of the general weakening of the national economy, increased financial instability of many borrowers and the declining value of their assets. As a result, lenders may become insolvent or tighten their lending standards, which could make it more difficult for us to borrow under our revolving credit facility, refinance our existing indebtedness or to obtain other financing on favorable terms or at all. Our access to funds under the senior secured credit facility is dependent upon the ability of our lenders to meet their funding commitments. Our financial condition and results of operations would be adversely affected if we were unable to draw funds under our senior secured credit facility because of a lender default or to obtain other cost-effective financing.

Longer term disruptions in the capital and credit markets as a result of uncertainty, changing or increased regulation, reduced alternatives or failures of significant financial institutions could adversely affect our access to liquidity needed for our business. Any disruption could require us to take measures to conserve cash until the markets stabilize or until alternative credit arrangements or other funding for our business can be arranged. Such measures could include deferring capital expenditures and reducing or eliminating other discretionary uses of cash.

As a result of the SCHIP Extension Act, which prohibits the establishment and classification of new LTCHs or satellites during the three calendar years commencing on December 29, 2007, we have stopped all new LTCH development. However, we continue to evaluate opportunities to develop rehabilitation hospitals, including the development of rehabilitation hospitals through joint ventures with others. We also intend to open new outpatient rehabilitation clinics in local areas that we currently serve where we can benefit from existing referral relationships and brand awareness to produce incremental growth.

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Commitments and Contingencies

The following table summarizes contractual obligations at December 31, 2008, and the effect such obligations are expected to have on liquidity and cash flow in future periods. Reserves for uncertain tax positions of $24.3 million have been excluded from the table below as we cannot reasonably estimate the amounts or periods in which these liabilities will be paid.

	Payments Due by Year				
Contractual Obligations	**Total**	**2009**	**2010-2012**	**2013-2014**	**After 2014**
			(in thousands)		
75/8% senior subordinated notes	$ 658,000	$	$	$	$ 658,000
Senior secured credit facility	806,500	6,800	799,700(3)		
10% senior subordinated notes(1)	135,603				135,603
Senior floating rate notes	175,000				175,000
Seller notes	1,282	416	866		
Capital lease obligations	1,640	426	1,214		
Other debt obligations	1,900	1,404	496		
Total debt	1,779,925	9,046	802,276		968,603
Interest(2)	644,385	129,004	317,366	165,940	32,075
Letters of credit outstanding	28,952		28,952		
Purchase obligations	3,145	2,301	844		
Construction contracts	15,819	15,819			
Naming, promotional and sponsorship agreement	53,822	2,619	8,226	5,807	37,170
Operating leases	490,976	108,438	181,779	52,002	148,757
Related party operating leases	46,425	2,978	9,079	6,524	27,844
Total contractual cash obligations	$ 3,063,449	$ 270,205	$ 1,348,522	$ 230,273	$ 1,214,449

(1) Reflects the balance sheet liability of our 10% senior subordinated notes calculated in accordance with GAAP. The balance sheet liability so reflected is less than the $150.0 million aggregate principal amount of such notes that were issued with an original issued discount. The remaining unamortized original issue discount was $14.4 million at December 31, 2008. Interest on the 10% senior subordinated notes accrued on the full principal amount thereof and we will be obligated to repay the full principal thereof at maturity or upon any mandatory or voluntary prepayment thereof. On any interest payment date on or after February 24, 2010, we will be obligated to pay an amount of accrued original issue discount on the 10% senior subordinated notes if necessary to ensure that the notes will not be considered applicable high yield discount obligations within the meaning of the Internal Revenue Code of 1986, as amended. The $150.0 million aggregate principal payable at maturity on our 10% senior subordinated notes would be reduced by prior payments of accrued original issue discount.

(2) The interest obligation was calculated using the average interest rate at December 31, 2008 of 5.7% for the senior secured credit facility, the stated interest rate for the 75/8% senior subordinated notes and the 10% senior subordinated notes, 10.2% for the senior floating rate notes and 6.0% for seller notes, capital lease obligations

and other debt obligations.

(3) Pursuant to Amendment No. 3 to our senior secured credit facility, $384.5 million principal amount of Tranche B term loans under the senior secured credit facility is now due in 2014.

Inflation

The healthcare industry is labor intensive. Wages and other expenses increase during periods of inflation and when labor shortages occur in the marketplace. In addition, suppliers pass along rising costs to us in the form of higher prices. We have implemented cost control measures, including our case and resource management program, to curtail increases in operating costs and expenses. We cannot predict our ability to cover or offset future cost increases.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (SFAS No. 168). SFAS No. 168 stipulates the FASB Accounting Standards Codification is the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. SFAS No. 168 is effective for financial statements issued for

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interim and annual periods ending after September 15, 2009. The implementation of this standard will not have a material impact on our consolidated financial statements.

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS No. 167). SFAS No. 167 changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting or similar rights should be consolidated. SFAS No. 167 will require a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure related to that involvement. SFAS No. 167 is effective for annual and interim reporting periods beginning after November 15, 2009. The adoption of SFAS No. 167 is not expected to have a material impact on our consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets (SFAS No. 166). SFAS No. 166 is a revision to SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and will require additional disclosure about the transfers of financial assets, including securitization transactions, and additional disclosure in cases where entities have continuing exposure to the risks related to transferred financial assets. SFAS No. 166 eliminates the concept of qualifying special-purpose entity and changes the requirements for derecognizing financial assets. SFAS No. 166 is effective for annual and interim reporting periods beginning after November 15, 2009. The adoption of SFAS No. 166 is not expected to have a material impact on our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS No. 165). SFAS No. 165 provides general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The statement sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. The statement also sets forth the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements. Furthermore, this statement identifies the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The Company adopted SFAS No. 165 during the second quarter of 2009.

In April 2009, FASB issued FASB Staff Position (FSP) No. 141R-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies (FSP 141R-1). FSP 141R-1 amends the provisions in SFAS No. 141R, Business Combinations, Revised (SFAS No. 141R), for the initial recognition and measurement, subsequent measurement and accounting, and disclosures for assets and liabilities arising from contingencies in business combinations. FSP 141R-1 eliminates the distinction between contractual and non-contractual contingencies, including the initial recognition and measurement criteria in SFAS No. 141R and instead carries forward most of the provisions in SFAS No. 141, Business Combinations, for acquired contingencies. FSP 141R-1 was effective for contingent assets and contingent liabilities acquired in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of FSP 141R-1 did not have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which will require that the fair value disclosures for all financial instruments within the scope of SFAS No. 107, Disclosures about Fair Value of Financial Instruments , be included in interim financial statements. This FSP also requires entities to disclose the method and significant assumptions used to estimate the fair value of financial instruments on an interim and annual basis and to highlight any changes from prior periods. FSP FAS 107-1 and APB 28-1 was effective for interim periods ending after June 15, 2009. The adoption of FSP 107-1 and APB 28-1 did not have an impact on our consolidated financial statements.

In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, provides additional guidance for estimating fair value in accordance with SFAS No. 157 when the volume and level of activity for the asset or liability have decreased significantly. FSP FAS 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly. The provisions of FSP FAS 157-4 were effective

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for the interim period ending on June 30, 2009. The adoption of FSP FAS 157-4 did not have an impact on our consolidated financial statements.

On January 1, 2009, we adopted SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 (SFAS No. 160). Upon adoption of this standard, minority interest is now referred to as non-controlling interest and has been reclassified from the mezzanine section of the balance sheet to the equity section. In addition, non-controlling interest is now deducted from net income to obtain net income attributable to Holdings. The consolidated financial statements have been retrospectively adjusted to give effect to the requirements of SFAS No. 160.

Quantitative and Qualitative Disclosures About Market Risk

We are subject to interest rate risk in connection with our long-term indebtedness. Our principal interest rate exposure relates to the loans outstanding under our senior secured credit facility and senior floating rate notes. As of June 30, 2009, Select had $768.1 million in term and revolving loans outstanding under our senior secured credit facility, which bear interest at variable rates. On June 13, 2005, Select entered into a five year interest rate swap transaction with an effective date of August 22, 2005. On March 8, 2007 and November 16, 2007, Select entered into two additional interest rate swap transactions for three years with effective dates of May 22, 2007 and November 23, 2007, respectively. Select entered into the swap transactions to mitigate the risks of future variable rate interest payments. The notional amount of the interest rate swaps are $500.0 million and the underlying variable rate debt is associated with the senior secured credit facility. Each eighth point change in interest rates on the variable rate portion of our long-term indebtedness would result in a $0.3 million annual change in interest expense on our term loans.

In conjunction with the issuance of the senior floating rate notes, Select entered into two swap transactions with an effective date of September 29, 2005 to mitigate the risks of future variable rate interest payments associated with this debt. The notional amount of the interest rate swaps total $175.0 million and the swaps are for a period of four years.

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BUSINESS

Overview

We believe that we are one of the largest operators of both specialty hospitals and outpatient rehabilitation clinics in the United States based on number of facilities. As of June 30, 2009, we operated 87 long term acute care hospitals, or LTCHs and five inpatient rehabilitation facilities, or IRFs in 25 states, and 948 outpatient rehabilitation clinics in 37 states and the District of Columbia. We also provide medical rehabilitation services on a contract basis at nursing homes, hospitals, assisted living and senior care centers, schools and worksites. We began operations in 1997 under the leadership of our current management team, including our co-founders, Rocco A. Ortenzio and Robert A. Ortenzio, who have a combined 68 years of experience in the healthcare industry. Under this leadership, we have grown our business from its founding to a business that generated net operating revenue of $2,153.4 million for the year ended December 31, 2008.

Business Segments and Strategy

We manage our company through two business segments, our specialty hospital and our outpatient rehabilitation segments. We derived approximately 69% and 70% of net operating revenues and 78% and 79% of our income from operations from our specialty hospital segment; and approximately 31% and 30% of net operating revenues and 22% and 21% of our income from operations from our outpatient rehabilitation segment, for the year ended December 31, 2008 and the six months ended June 30, 2009, respectively. Our specialty hospital segment consists of hospitals designed to serve the needs of long term stay acute patients and hospitals designed to serve patients who require intensive inpatient medical rehabilitation. Our outpatient rehabilitation business consists of clinics and contract services that provide physical, occupational and speech rehabilitation services.

Specialty Hospitals

We are a leading operator of specialty hospitals in the United States, with 92 facilities throughout 25 states, as of June 30, 2009. All 87 of our long term acute care hospitals are currently certified by the federal Medicare program as long term acute care hospitals. All five of our acute medical rehabilitation hospitals are currently certified by the federal Medicare program as inpatient rehabilitation facilities. For the year ended December 31, 2008 and the six months ended June 30, 2009, approximately 63% of the net operating revenues of our specialty hospital segment came from Medicare reimbursement. As of June 30, 2009, we operated a total of 4,160 available licensed beds and employed approximately 12,700 people in our specialty hospital segment, consisting primarily of registered or licensed nurses, respiratory therapists, physical therapists, occupational therapists and speech therapists.

Patients are typically admitted to our specialty hospitals from general acute care hospitals. These patients have specialized needs, and serious and often complex medical conditions such as respiratory failure, neuromuscular disorders, traumatic brain and spinal cord injuries, strokes, non-healing wounds, cardiac disorders, renal disorders and cancer. Given their complex medical needs, these patients generally require a longer length of stay than patients in a general acute care hospital and benefit from being treated in a specialty hospital that is designed to meet their unique medical needs. The average length of stay for patients in our specialty hospitals was 26 days in our long term acute care hospitals and 16 days in our inpatient rehabilitation facilities, for the six months ended June 30, 2009.

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Below is a table that shows the distribution by medical condition (based on primary diagnosis) of patients in our hospitals for the year ended December 31, 2008:

Medical Condition	Distribution of Patients
Respiratory disorders	34%
Neuromuscular disorders	32
Cardiac disorders	9
Wound care	8
Other	17
Total	100%

We believe that we provide our services on a more cost-effective basis than a typical general acute care hospital because we provide a much narrower range of services. We believe that our services are therefore attractive to healthcare payors who are seeking to provide the most cost-effective level of care to their enrollees. Additionally, we continually seek to increase our admissions by expanding and improving our relationships with the physicians and general acute care hospitals that refer patients to our facilities. We also maintain a strong focus on the provision of high-quality medical care within our facilities and believe that this operational focus is in part reflected in our specialty hospital accreditation by The Joint Commission, previously known as the Joint Commission on Accreditation of Healthcare Organizations, and the Commission on Accreditation of Rehabilitation Facilities. The Joint Commission and the Commission on Accreditation of Rehabilitation Facilities are independent, not-for-profit organizations that establish standards related to the operation and management of health care facilities. Each of our accredited facilities must regularly demonstrate to a survey team conformance to the applicable standards. When a survey is completed, the facility receives a survey report that acknowledges best practices, contains suggestions for improving services, and makes recommendations for improvement based on conformance to the standards.

When a patient is referred to one of our hospitals by a physician, case manager, discharge planner, health maintenance organization or insurance company, a clinical liaison along with a case manager from our company makes an assessment to determine the care required. Based on the determinations reached in this clinical assessment, an admission decision is made by the attending physician.

Upon admission, an interdisciplinary team reviews a new patient s condition. The interdisciplinary team is comprised of a number of clinicians and may include any or all of the following: an attending physician; a specialty nurse; a physical, occupational or speech therapist; a respiratory therapist; a dietician; a pharmacist; and a case manager. Upon completion of an initial evaluation by each member of the treatment team, an individualized treatment plan is established and implemented. The case manager coordinates all aspects of the patient s hospital stay and serves as a liaison with the insurance carrier s case management staff when appropriate. The case manager communicates progress, resource utilization, and treatment goals between the patient, the treatment team and the payor.

Each of our specialty hospitals has an onsite management team consisting of a chief executive officer, a director of clinical services and a director of provider relations. These teams manage local strategy and day-to-day operations, including oversight of clinical care and treatment. They also assume primary responsibility for developing relationships with the general acute care providers and clinicians in the local areas we serve that refer patients to our specialty hospitals. We provide our hospitals with centralized accounting, payroll, legal, reimbursement, human resources, compliance, management information systems and billing and collection services. The centralization of

these services improves efficiency and permits hospital staff to spend more time on patient care.

We operate the majority of our long term acute care hospitals as hospitals within hospitals or as satellites, which we collectively refer to as HIHs. A long term acute care hospital that operates as an HIH leases space from a general acute care host hospital and operates as a separately licensed hospital within the host hospital, or on the same campus as the host hospital. In contrast, a free-standing long term acute care hospital does not operate on a

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host hospital campus. As a result of the HIH regulatory changes discussed in further detail in Government Regulations, we developed and implemented a plan that included, among other things, relocating certain facilities to alternative settings, building or buying additional free-standing hospitals and closing some of our facilities. The significant changes associated with this plan have been completed. As a result of this plan, of the 87 long term acute care hospitals we operated as of June 30, 2009, 65 were operated as HIHs and 22 were operated as free-standing hospitals.

All Medicare payments to our long term acute care hospitals are made in accordance with the prospective payment system specifically applicable to long term acute care hospitals, referred to as LTCH-PPS. Under LTCH-PPS, a long term acute care hospital is paid a pre-determined fixed amount depending upon the long term care diagnosis-related group, or LTC-DRG, to which each patient is assigned. LTCH-PPS includes special payment policies that adjust the payments for some patients based on a variety of factors. Some of these special payment policies have been the subject of recent regulatory developments. See Government Regulations and Management s Discussion and Analysis of Financial Condition and Results of Operations Regulatory Changes.

Specialty Hospital Strategy

Focus on Specialized Inpatient Services. We serve highly acute patients and patients with debilitating injuries that cannot be adequately cared for in a less medically intensive environment, such as a skilled nursing facility. Generally, patients in our specialty hospitals require longer stays and higher levels of clinical care than patients treated in general acute care hospitals. Our patients average length of stay in our specialty hospitals was 24 days for the year ended December 31, 2008.

Provide High Quality Care and Service. We believe that our specialty hospitals serve a critical role in comprehensive healthcare delivery. Through our specialized treatment programs and staffing models, we treat patients with acute, complex and specialized medical needs who are typically referred to us by general acute care hospitals. Our specialized treatment programs focus on specific patient needs and medical conditions such as ventilator weaning programs, wound care protocols and rehabilitation programs for brain trauma and spinal cord injuries. Our responsive staffing models ensure that patients have the appropriate clinical resources over the course of their stay. We believe that we are recognized for providing quality care and service, as evidenced by accreditation by The Joint Commission and the Commission on Accreditation of Rehabilitation Facilities. We also believe we develop brand loyalty in the local areas we serve allowing us to strengthen our relationships with physicians and other referral sources and drive additional patient volume to our hospitals.

Our treatment and staffing programs benefit patients because they give our clinicians access to the regimens that we have found to be most effective in treating various conditions such as respiratory failure, non-healing wounds, brain and spinal cord injuries, strokes and neuromuscular disorders. In addition, we combine or modify these programs to provide a treatment plan tailored to meet our patients unique needs.

The quality of the patient care we provide is continually monitored using several measures, including patient, payor and physician satisfaction surveys, as well as clinical outcomes analyses. Quality measures are collected monthly and reported quarterly and annually. In order to benchmark ourselves against other healthcare organizations, we have contracted with outside vendors to collect our clinical and patient satisfaction information and compare it to other healthcare organizations. The information collected is reported back to each hospital, to our corporate office, and directly to The Joint Commission. As of June 30, 2009, The Joint Commission had fully accredited 91 of our 92 hospitals and partially accredited one hospital awaiting a full accreditation survey. Three of our five inpatient rehabilitation facilities have also received accreditation from the Commission on Accreditation of Rehabilitation Facilities. Two of our inpatient rehabilitation facilities have not yet been surveyed by the Commission on Accreditation of Rehabilitation Facilities. See Government Regulations Licensure Accreditation.

Reduce Operating Costs. We continually seek to improve operating efficiency and reduce costs at our hospitals by standardizing operations and centralizing key administrative functions. These initiatives include:

- optimizing staffing based on our occupancy and the clinical needs of our patients;

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centralizing administrative functions such as accounting, finance, payroll, legal, reimbursement, compliance, human resources and billing and collection;

standardizing management information systems to aid in financial reporting as well as billing and collecting; and

participating in group purchasing arrangements to receive discounted prices for pharmaceuticals and medical supplies.

Increase Higher Margin Commercial Volume. With reimbursement rates from commercial insurers typically higher than the federal Medicare program, we have focused on continued expansion of our relationships with commercial insurers to increase our volume of patients with commercial insurance in our specialty hospitals. Although the level of care we provide is complex and staff intensive, we typically have lower relative operating expenses than a general acute care hospital because we provide a much narrower range of patient services at our hospitals. We believe that commercial payors seek to contract with our hospitals because we offer patients high quality, cost- effective care at more attractive rates than general acute care hospitals. We also offer commercial enrollees customized treatment programs not typically offered in general acute care hospitals.

Develop New Inpatient Facilities. As a result of the Medicare, Medicaid, and SCHIP Extension Act of 2007, or SCHIP Extension Act, which prohibits the establishment and classification of new LTCHs or satellites during the three calendar years commencing on December 29, 2007, we have stopped all LTCH development, except for LTCHs currently under construction that are excluded from the moratorium. We expect to continue evaluating opportunities to develop new inpatient rehabilitation facilities. We have a dedicated development team with significant experience in speciality hospital development. In addition, three predecessor companies founded by our Executive Chairman and/or co-founded by our Chief Executive Officer focused on the development and operation of inpatient rehabilitation hospitals.

By leveraging the experience of our senior management and dedicated development team, we believe that we are well positioned to capitalize on development opportunities. When we target a new local area to serve, our development team conducts an extensive review of the area s referral patterns and commercial insurance to determine the general reimbursement trends and payor mix. Ultimately, when we determine a location for the development of a new specialty hospital, we evaluate the opportunities in the area for the construction of new space or the leasing and renovation of existing space. During construction or renovation, the project is transitioned to our start-up team, which is experienced in preparing a specialty hospital for opening. The start-up team oversees equipment purchases, licensure procedures and the recruitment of a full-time management team. After the facility is opened, responsibility for its management is transitioned to this new management team and our corporate operations group.

Pursue Opportunistic Acquisitions. In addition to our development initiatives, we may grow our network of specialty hospitals through opportunistic acquisitions. Our immediate focus is on acquisitions of inpatient rehabilitation facilities, although we will still consider acquisitions of long term acute care hospitals if they are at attractive valuations. We believe we have historically been able to obtain assets for what we believe are attractive valuations. When we acquire a hospital or a group of hospitals, a team of our professionals is responsible for formulating and executing an integration plan. We have generally been able to increase margins at acquired facilities by adding clinical programs that attract commercial payors, centralizing administrative functions and implementing our standardized staffing models and resource management programs. Since our founding in 1997, we have made a total of four significant specialty hospital acquisitions comprising 54 long term acute care hospitals and four inpatient rehabilitation facilities for a total of $496.4 million in aggregate consideration.

Outpatient Rehabilitation

We believe that we are the largest operator of outpatient rehabilitation clinics in the United States based on number of facilities, with 948 facilities throughout 37 states and the District of Columbia, as of June 30, 2009. Typically, each of our clinics is located in a medical complex or retail location. As of June 30, 2009, our outpatient rehabilitation segment employed approximately 8,300 people.

In our clinics and through our contractual relationships, we provide physical, occupational and speech rehabilitation programs and services. We also provide certain specialized programs such as hand therapy or sports

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performance enhancement that treat sports and work related injuries, musculoskeletal disorders, chronic or acute pain and orthopedic conditions. The typical patient in one of our clinics suffers from musculoskeletal impairments that restrict his or her ability to perform normal activities of daily living. These impairments are often associated with accidents, sports injuries, strokes, heart attacks and other medical conditions. Our rehabilitation programs and services are designed to help these patients minimize physical and cognitive impairments and maximize functional ability. We also provide services designed to prevent short term disabilities from becoming chronic conditions. Our rehabilitation services are provided by our professionals including licensed physical therapists, occupational therapists, speech-language pathologists and respiratory therapists.

Outpatient rehabilitation patients are generally referred or directed to our clinics by a physician, employer or health insurer who believes that a patient, employee or member can benefit from the level of therapy we provide in an outpatient setting. We believe that our services are attractive to healthcare payors who are seeking to provide the most cost-effective level of care to their enrollees. In addition to providing therapy in our outpatient clinics, we provide medical rehabilitation management services on a contract basis at nursing homes, hospitals, schools, assisted living and senior care centers and worksites. In our outpatient rehabilitation segment, approximately 90% of our net operating revenues come from commercial payors, including healthcare insurers, managed care organizations and workers compensation programs, contract management services and private pay sources. The balance of our reimbursement is derived from Medicare and other government sponsored programs.

Outpatient Rehabilitation Strategy

Provide High Quality Care and Service. We are focused on providing a high level of service to our patients throughout their entire course of treatment. To measure satisfaction with our service we have developed surveys for both patients and physicians. Our clinics utilize the feedback from these surveys to continuously refine and improve service levels. We believe that by focusing on quality care and offering a high level of customer service we develop brand loyalty in the local areas we serve. This high quality of care and service allows us to strengthen our relationships with referring physicians, employers and health insurers and drive additional patient volume.

Increase Market Share. We strive to establish a leading presence within the local areas we serve. To increase our presence, we seek to expand our services and programs and to continue to provide high quality care and strong customer service. This allows us to realize economies of scale, heightened brand loyalty, workforce continuity and increased leverage when negotiating payor contracts.

Expand Rehabilitation Programs and Services. Through our local clinical directors of operations and clinic managers within their service areas, we assess the healthcare needs of the areas we serve. Based on these assessments, we implement additional programs and services specifically targeted to meet demand in the local community. In designing these programs we benefit from the knowledge we gain through our national network of clinics. This knowledge is used to design programs that optimize treatment methods and measure changes in health status, clinical outcomes and patient satisfaction.

Optimize the Profitability of our Payor Contracts. We rigorously review payor contracts up for renewal and potential new payor contracts to optimize our profitability. Before we enter into a new contract with a commercial payor, we evaluate it with the aid of our contract management system. We assess potential profitability by evaluating past and projected patient volume, clinic capacity, and expense trends. We create a retention strategy for the top performing contracts and a renegotiation strategy for contracts that do not meet our defined criteria. We believe that our size and our strong reputation enables us to negotiate favorable outpatient contracts with commercial insurers.

Maintain Strong Employee Relations. We believe that the relationships between our employees and the referral sources in their communities are critical to our success. Our referral sources, such as physicians and healthcare case

managers, send their patients to our clinics based on three factors: the quality of our care, the service we provide and their familiarity with our therapists. We seek to retain and motivate our therapists by implementing a performance-based bonus program, a defined career path with the ability to be promoted from within, timely communication on company developments and internal training programs. We also focus on empowering our employees by giving them a high degree of autonomy in determining local area strategy. This management

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approach reflects the unique nature of each local area in which we operate and the importance of encouraging our employees to assume responsibility for their clinic s performance.

Pursue Opportunistic Acquisitions. We may grow our network of outpatient rehabilitation facilities through opportunistic acquisitions. We significantly expanded our network with the 2007 acquisition of the outpatient rehabilitation division of HealthSouth Corporation, consisting of 569 clinics in 35 states and the District of Columbia, including 18 states in which we did not previously have outpatient rehabilitation facilities. We believe our size and centralized infrastructure allow us to take advantage of operational efficiencies and increase margins at acquired facilities.

Other Services

Other services (which accounted for less than 1% of our net operating revenues for the six months ended June 30, 2009) include corporate services and certain non-healthcare services.

Our Competitive Strengths

We believe that the success of our business model is based on a number of competitive strengths, including our position as a leading operator in each of our business segments, proven financial performance and strong cash flow, significant scale, experience in completing and integrating acquisitions, ability to capitalize on consolidation opportunities and an experienced management team.

Leading Operator in Distinct but Complementary Lines of Business. We believe that we are a leading operator in each of our principal business segments, based on number of facilities in the United States. Our leadership position and reputation as a high quality, cost-effective health care provider in each of our business segments allows us to attract patients and employees, aids us in our marketing efforts to payors and referral sources and helps us negotiate payor contracts. In our specialty hospital segment, we operated 87 long term acute care hospitals with 3,757 available licensed beds in 25 states and five inpatient rehabilitation facilities with 403 beds in three states and derived approximately 70% of net operating revenues from these operations, for the six months ended June 30, 2009. In our outpatient rehabilitation segment, we operated 948 outpatient rehabilitation clinics in 37 states and the District of Columbia and derived approximately 30% of net operating revenues from these operations, for the six months ended June 30, 2009. With these leading positions in the areas we serve, we believe that we are well-positioned to benefit from the rising demand for medical services due to an aging population in the United States, which will drive growth across our business lines.

Proven Financial Performance and Strong Cash Flow. We have established a track record of improving the financial performance of our facilities due to our disciplined approach to revenue growth, expense management and an intense focus on free cash flow generation. This includes regular review of specific financial metrics of our business to determine trends in our revenue generation, expenses, billing and cash collection. Based on the ongoing analysis of such trends, we make adjustments to our operations to optimize our financial performance and cash flow.

Significant Scale. By building significant scale in each of our business segments, we have been able to leverage our operating costs by centralizing administrative functions at our corporate office. As a result, we have been able to minimize our general and administrative expense as a percentage of revenues, which was 2.3% for the six months ended June 30, 2009.

Well-Positioned to Capitalize on Consolidation Opportunities. We believe that we are well-positioned to capitalize on consolidation opportunities within each of our business segments and selectively augment our internal growth. We believe that each of our business segments is highly fragmented, with many of the nation s long term acute care

hospitals, inpatient rehabilitation facilities and outpatient rehabilitation facilities being operated by independent operators lacking national or broad regional scope. With our geographically diversified portfolio of facilities in the United States, we believe that our footprint provides us with a wide-ranging perspective on multiple potential acquisition opportunities.

Experience in Successfully Completing and Integrating Acquisitions. From our inception in 1997 through 2008, we completed six significant acquisitions for approximately $894.8 million in aggregate consideration. We

believe that we have improved the operating performance of these facilities over time by applying our standard operating practices and by realizing efficiencies from our centralized operations and management.

Experienced and Proven Management Team. Prior to co-founding our company with our current Chief Executive Officer, our Executive Chairman founded and operated three other healthcare companies focused on inpatient and outpatient rehabilitation services. In addition, our four senior operations executives have an average of over 31 years of experience in the healthcare industry, including extensive experience working together for our company and for past companies focused on operating acute rehabilitation hospitals and outpatient rehabilitation facilities. 10 of our 16 corporate officers worked together at Continental Medical Systems, Inc., a developer and operator of inpatient rehabilitation facilities that was managed under the leadership of Rocco A. Ortenzio and Robert A. Ortenzio from its inception in 1986 until it was sold in 1995. Over the course of their operating history, our senior management team has received national recognition for its management and business operations, including selection for the Forbes Platinum 400 List, as one of America s Best Managed Companies.

Industry

In the United States, spending on healthcare was expected to be 16.6% of the gross domestic product in 2008 and is projected to grow at 6.2% compounded annually over the next ten years, according to the Centers for Medicare & Medicaid Services, or CMS. An important factor driving healthcare spending is increased consumption of services due to the aging of the population. The number of individuals age 65 and older has grown 1.2% compounded annually over the past 20 years and is expected to grow 2.9% compounded annually over the next 20 years, approximately three times faster than the overall population, according to the U.S. Census Bureau. We believe that an increasing number of individuals age 65 and older will drive demand for our specialized medical services.

For individuals age 65 and older, the primary source of health insurance is the federal Medicare program. Medicare utilizes distinct payment methodologies for services provided in long term acute care hospitals, inpatient rehabilitation facilities and outpatient rehabilitation clinics. In the federal fiscal year 2007, Medicare payments for long term acute care hospitals services accounted for 1.0% of overall Medicare outlays and Medicare payments for inpatient rehabilitation services accounted for 1.4% according to the Medicare Payment Advisory Commission. Due to recent regulatory changes enacted in part to slow growth, over the next five years Medicare payments for long term acute care hospital services are projected to grow approximately 4% compounded annually and Medicare payments for inpatient rehabilitation services are projected to grow approximately 2% compounded annually, which compares with approximately 7% compound annual growth projected for the overall Medicare program, according to information provided by the Office of the Actuary of the U.S. Department of Health and Human Services.

Sources of Net Operating Revenues

The following table presents the approximate percentages by source of net operating revenue received for healthcare services we provided for the periods indicated:

	Year Ended December 31,			Six Months Ended June 30,	
Net Operating Revenues by Payor Source[1]	**2006**	**2007**	**2008**	**2008**	**2009**
Medicare	53.2%	48.0%	46.2%	46.0%	46.8%
Commercial insurance[2]	40.0%	44.2%	46.3%	46.5%	45.7%
Private and other[3]	5.0%	5.5%	5.4%	5.5%	5.4%

Medicaid	1.8%	2.3%	2.1%	2.0%	2.1%
Total	100.0%	100.0%	100.0%	100.0%	100%

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(1) This table excludes the net operating revenues of our Canadian operations which were sold on March 1, 2006 and are now reported as a discontinued operation.
(2) Includes commercial healthcare insurance carriers, health maintenance organizations, preferred provider organizations, workers compensation and managed care programs.
(3) Includes self payors, contract management services and non-patient related payments. Self pay revenues represent less than 1% of total net operating revenues.

Government Sources

Medicare is a federal program that provides medical insurance benefits to persons age 65 and over, some disabled persons, and persons with end-stage renal disease. Medicaid is a federal-state funded program, administered by the states, which provides medical benefits to individuals who are unable to afford healthcare. All of our hospitals are currently certified as Medicare providers. Our outpatient rehabilitation clinics regularly receive Medicare payments for their services. Additionally, many of our specialty hospitals participate in state Medicaid programs. Amounts received under the Medicare and Medicaid programs are generally less than the customary charges for the services provided. In recent years there have been significant changes made to the Medicare and Medicaid programs. Since a significant portion of our revenues come from patients under the Medicare program, our ability to operate our business successfully in the future will depend in large measure on our ability to adapt to changes in the Medicare program. See Government Regulations Overview of U.S. and State Government Reimbursements.

Non-Government Sources

An increasing amount of our net operating revenues continue to come from commercial and private payor sources. These sources include insurance companies, workers compensation programs, health maintenance organizations, preferred provider organizations, other managed care companies and employers, as well as by patients directly. Patients are generally not responsible for any difference between customary charges for our services and amounts paid by Medicare and Medicaid programs, insurance companies, workers compensation companies, health maintenance organizations, preferred provider organizations and other managed care companies, but are responsible for services not covered by these programs or plans, as well as for deductibles and co-insurance obligations of their coverage. The amount of these deductibles and co-insurance obligations has increased in recent years. Collection of amounts due from individuals is typically more difficult than collection of amounts due from government or business payors.

The Merger Transactions

On February 24, 2005, EGL Acquisition Corp. was merged with and into Select, with Select continuing as the surviving corporation and a wholly owned subsidiary of Holdings. The merger was completed pursuant to an agreement and plan of merger, dated as of October 17, 2004, among EGL Acquisition Corp., Holdings and Select. Holdings and EGL Acquisition Corp. were Delaware corporations formed by Welsh Carson for purposes of engaging in the merger and the related transactions described below.

Upon the consummation of the merger, Select became a wholly owned subsidiary of Holdings and all of the capital stock of Holdings was owned by an investor group that includes Welsh Carson and Thoma Cressey, and certain other rollover investors that participated in the merger. We refer to those other investors as the continuing investors. Our continuing investors include Rocco A. Ortenzio, our Executive Chairman and the chairman of our board of directors, Robert A. Ortenzio, our Chief Executive Officer and a member of our board of directors, certain other investors who are members of or affiliated with the Ortenzio family, certain individuals affiliated with Welsh Carson, including Russell L. Carson, a member of our board of directors and a founding general partner of Welsh, Carson, Anderson &

Stowe, Bryan C. Cressey, a member of our board of directors and a founding partner of Thoma Cressey, various investment funds affiliated with Thoma Cressey, Patricia A. Rice, our President and Chief Operating Officer, Martin F. Jackson, our Executive Vice President and Chief Financial Officer, S. Frank Fritsch, our Executive Vice President and Chief Human Resources Officer, Michael E. Tarvin, our Executive Vice President, General Counsel and Secretary, James J. Talalai, our Executive Vice President and Chief Information Officer, and

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Scott A. Romberger, our Senior Vice President, Controller and Chief Accounting Officer. The continuing investors purchased our common stock at a price of $3.33 per share and our preferred stock at a price of $26.90 per share. Immediately prior to the merger, shares of common stock of Select which were owned by our continuing investors were contributed to Holdings in exchange for equity securities of Holdings. For purposes of such exchange, these rollover shares were valued at $152.0 million in the aggregate, or $18.00 per share (the per share merger consideration). Upon consummation of the merger, these rollover shares were cancelled without payment of any merger consideration.

The amount of funds and rollover equity used to consummate the Merger Transactions was $2,443.1 million, including:

$1,827.7 million to pay Select s then existing stockholders (other than rollover stockholders) and option holders all amounts due under the merger agreement;

$152.0 million of rollover equity from our continuing investors;

$344.2 million to repay existing indebtedness; and

$119.2 million to pay related fees and expenses, including premiums, consent fees and interest payable in connection with the tender offers and consent solicitations for Select s existing senior subordinated notes.

The Merger Transactions were financed by:

a cash equity investment in Holdings of $570.0 million by an investor group led by Welsh Carson and Thoma Cressey (the net proceeds of which were contributed by Holdings to Select) and a rollover equity investment in Holdings of $152.0 million by our continuing investors;

Holdings issuance and sale of senior subordinated notes, preferred stock and common stock to WCAS Capital Partners IV, L.P., an investment fund affiliated with Welsh Carson, Rocco A. Ortenzio, Robert A. Ortenzio and certain other investors who are members of or affiliated with the Ortenzio family, for an aggregate purchase price of $150.0 million (the net proceeds of which were contributed by Holdings to Select);

borrowings by us of $580.0 million in term loans and $200.0 million in revolving loans under our senior secured credit facility;

existing cash on hand of $131.1 million; and

the issuance of $660.0 million in aggregate principal amount of Select s 75/8% senior subordinated notes.

In connection with the merger, Select commenced tender offers to acquire all of its 91/2% senior subordinated notes due 2009 and all of its 71/2% senior subordinated notes due 2013. In connection with each such tender offer Select sought consents to eliminate substantially all of the restrictive covenants and make other amendments to the indentures governing such notes. Upon completion of the tender offers on February 24, 2005, holders of all of Select s 71/2% senior subordinated notes and holders of approximately 96.7% of Select s 91/2% senior subordinated notes had delivered consents and tendered their notes in connection with such tender offers and consent solicitations.

As a result of the Merger Transactions, the majority of Select s assets and liabilities were adjusted to their fair value as of February 25, 2005. The excess of the total purchase price over the fair value of Select s tangible and identifiable intangible assets was allocated to goodwill, which is the subject of an annual impairment test. Additionally, pursuant

to Financial Accounting Standards Board Emerging Issues Task Force Issue No. 88-16 Basis in Leveraged Buyout Transactions, a portion of the equity related to our continuing stockholders was recorded at the stockholder s predecessor basis and a corresponding portion of the fair value of the acquired assets was reduced accordingly. By definition, our statements of financial position and results of operations subsequent to the Merger Transactions are not comparable to the same statements for the periods prior to the Merger Transactions due to the resulting change in basis.

In recommending the approval of the merger agreement and the merger to the board of directors, the special committee of our board of directors considered the material factors that it believed supported its recommendation, the most significant factor being that the merger consideration of $18.00 per share was payable in cash and

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represented a substantial premium over the market price of common stock of Select before the public announcement of the execution of the merger agreement.

Material Acquisitions

The growth of our business also has been attributable to our ability to successfully acquire and integrate other businesses. Since our inception in 1997 through June 30, 2009, we have completed six significant acquisitions for approximately $894.8 million in aggregate consideration. On June 30, 1998, we acquired American Transitional Hospitals, a wholly-owned subsidiary of Beverly Enterprises, Inc. and a provider of long term acute care hospital services, for approximately $62.8 million in cash and approximately $14.9 million in assumed liabilities. The American Transitional Hospital acquisition added 15 long term acute care hospitals. On December 16, 1998, we acquired Intensiva Healthcare Corporation, a provider of long term acute care hospital services, for approximately $103.6 million in cash and approximately $56.5 million in assumed liabilities. The Intensiva Healthcare Corporation acquisition added 22 long term acute care hospitals. On November 19, 1999, we acquired the Physical Rehabilitation and Occupational Health Division of NovaCare, Inc., for approximately $160.4 million consisting of cash and the assumption of seller notes. The NovaCare acquisition added 513 outpatient rehabilitation clinics. On September 2, 2003, we acquired Kessler Rehabilitation Corporation for approximately $230.0 million in cash and approximately $1.7 million of assumed indebtedness. The Kessler acquisition added four inpatient rehabilitation hospitals and 92 outpatient rehabilitation clinics. On January 1, 2005, we acquired SemperCare, Inc. for approximately $100.0 million in cash. The SemperCare acquisition added 17 long term acute care hospitals. Finally, on May 1, 2007, we acquired HealthSouth Corporation s outpatient rehabilitation division for approximately $245.0 million, reduced by approximately $7.0 million at closing for assumed indebtedness and other matters. We significantly expanded our network with the HealthSouth acquisition, consisting of 569 outpatient rehabilitation clinics in 35 states and the District of Columbia, including 18 states in which we did not previously have outpatient rehabilitation clinics. See Management s Discussion and Analysis of Financial Condition and Results of Operations Overview Acquisition of HealthSouth Corporation s Outpatient Rehabilitation Division.

Employees

As of June 30, 2009, we employed approximately 21,700 people throughout the United States. Approximately 15,000 of our employees are full time and the remaining approximately 6,700 are part time employees. Outpatient, contract therapy and physical rehabilitation and occupational health employees totaled approximately 8,300 and specialty hospital employees totaled approximately 12,700. The remaining approximately 700 employees were in corporate management, administration and other services.

Competition

We compete on the basis of pricing, the quality of the patient services we provide and the results that we achieve for our patients. The primary competitive factors in the long term acute care and inpatient rehabilitation businesses include quality of services, charges for services and responsiveness to the needs of patients, families, payors and physicians. Other companies operate long term acute care hospitals and inpatient rehabilitation facilities that compete with our hospitals, including large operators of similar facilities, such as Kindred Healthcare Inc. and HealthSouth Corporation. The competitive position of any hospital is also affected by the ability of its management to negotiate contracts with purchasers of group healthcare services, including private employers, managed care companies, preferred provider organizations and health maintenance organizations. Such organizations attempt to obtain discounts from established hospital charges. The importance of obtaining contracts with preferred provider organizations, health maintenance organizations and other organizations which finance healthcare, and its effect on a hospital s competitive position, vary from area to area, depending on the number and strength of such organizations.

Our outpatient rehabilitation clinics face competition principally from locally owned and managed outpatient rehabilitation clinics in the communities they serve and from selected national providers such as Physiotherapy Associates and U.S. Physical Therapy in selected local areas. Many of these clinics have longer operating histories and greater name recognition in these communities than our clinics, and they may have stronger relations with physicians in these communities on whom we rely for patient referrals.

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Facilities

We currently lease most of our facilities, including clinics, offices, specialty hospitals and our corporate headquarters. We own three of our five inpatient rehabilitation facilities and 12 of our long term acute care hospitals.

We lease all but four of our outpatient rehabilitation clinics and related offices, which, as of June 30, 2009, included 944 leased outpatient rehabilitation clinics throughout the United States. The outpatient rehabilitation clinics generally have a five year lease term and include options to renew. We also lease the majority of our long term acute care hospital facilities except for the facilities described above. As of June 30, 2009, in our LTCHs we had 65 hospital within hospital leases and 10 free-standing building leases.

We generally seek a five year lease for our long term acute care hospitals operated as HIHs, with an additional five year renewal at our option. We lease our corporate headquarters from companies owned by a related party affiliated with us through common ownership or management. Our corporate headquarters is approximately 132,138 square feet and is located in Mechanicsburg, Pennsylvania. We lease several other administrative spaces related to administrative and operational support functions. As of June 30, 2009, this comprised 12 locations throughout the United States with approximately 86,314 square feet in total.

The following is a list of our hospitals and the number of beds at each hospital as of June 30, 2009.

Hospital Name		City	State	Beds
Select Specialty Hospital	Birmingham	Birmingham	AL	38
Select Specialty Hospital	Fort Smith	Fort Smith	AR	32
Select Specialty Hospital	Little Rock	Little Rock	AR	43
Select Specialty Hospital	Arizona (Phoenix Downtown Campus)	Phoenix	AZ	33
Select Specialty Hospital	Phoenix	Phoenix	AZ	48
Select Specialty Hospital	Arizona (Scottsdale Campus)	Scottsdale	AZ	29
Select Specialty Hospital	Colorado Springs	Colorado Springs	CO	30
Select Specialty Hospital	Denver	Denver	CO	37
Select Specialty Hospital	Denver (South Campus)	Denver	CO	28
Select Specialty Hospital	Wilmington	Wilmington	DE	35
Select Specialty Hospital	Orlando (South Campus)	Edgewood	FL	40
Select Specialty Hospital	Gainesville	Gainesville	FL	44
Select Specialty Hospital	Palm Beach	Lake Worth	FL	60
Select Specialty Hospital	Miami	Miami	FL	47
Select Specialty Hospital	Orlando (North Campus)	Orlando	FL	35
Select Specialty Hospital	Panama City	Panama City	FL	30
Select Specialty Hospital	Pensacola	Pensacola	FL	54
Select Specialty Hospital	Tallahassee	Tallahassee	FL	29
Select Specialty Hospital	Atlanta	Atlanta	GA	27
Select Specialty Hospital	Augusta	Augusta	GA	80
Select Specialty Hospital	Savannah	Savannah	GA	36
Select Specialty Hospital	Quad Cities	Davenport	IA	50
Select Specialty Hospital	Beech Grove	Beech Grove	IN	40
Select Specialty Hospital	Evansville	Evansville	IN	60
Select Specialty Hospital	Fort Wayne	Fort Wayne	IN	32
Select Specialty Hospital	Northwest Indiana	Hammond	IN	70

Select Specialty Hospital	Kansas City	Overland Park	KS	40

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Hospital Name		City	State	Beds
Select Specialty Hospital	Topeka	Topeka	KS	34
Select Specialty Hospital	Wichita	Wichita	KS	60
Select Specialty Hospital	Lexington	Lexington	KY	41
Select Specialty Hospital	Northwest Detroit	Detroit	MI	36
Select Specialty Hospital	Flint	Flint	MI	26
Select Specialty Hospital	Grosse Pointe	Grosse Pointe Farms	MI	30
Select Specialty Hospital	Kalamazoo	Kalamazoo	MI	25
Select Specialty Hospital	Macomb County	Mount Clemens	MI	36
Select Specialty Hospital	Western Michigan	Muskegon	MI	31
Select Specialty Hospital	Pontiac	Pontiac	MI	30
Select Specialty Hospital	Saginaw	Saginaw	MI	32
Select Specialty Hospital	Downriver	Taylor	MI	40
Select Specialty Hospital	Ann Arbor	Ypsilanti	MI	36
Select Specialty Hospital	Western Missouri	Kansas	MO	34
Select Specialty Hospital	Springfield	Springfield	MO	44
Select Specialty Hospital	St. Louis	St. Louis	MO	33
Select Specialty Hospital	Gulfport	Gulfport	MS	61
Select Specialty Hospital	Jackson	Jackson	MS	53
Select Specialty Hospital	Durham	Durham	NC	30
Select Specialty Hospital	Winston-Salem	Winston-Salem	NC	42
Select Specialty Hospital	Omaha (Central Campus)	Omaha	NE	52
Kessler Institute for Rehabilitation (Welkind Campus)		Chester	NJ	72
Select Specialty Hospital	Northeast New Jersey	Rochelle Park	NJ	59
Kessler Institute for Rehabilitation (North Campus)		Saddle Brook	NJ	112
Kessler Institute for Rehabilitation (West Campus)		West Orange	NJ	143
Select Specialty Hospital	Akron	Akron	OH	60
Select Specialty Hospital	Northeast Ohio (Canton Campus)	Canton	OH	30
Select Specialty Hospital	Cincinnati	Cincinnati	OH	35
Select Specialty Hospital	Columbus	Columbus	OH	152
Select Specialty Hospital	Columbus (Mt. Carmel Campus)	Columbus	OH	24
Select Specialty Hospital	Youngstown	Youngstown	OH	31
Select Specialty Hospital	Youngstown (Boardman Campus)	Youngstown	OH	20
Select Specialty Hospital	Zanesville	Zanesville	OH	35
Select Specialty Hospital	Oklahoma City	Oklahoma City	OK	72
Select Specialty Hospital	Tulsa/Midtown (Midtown Campus)	Tulsa	OK	56
Select Specialty Hospital	Tulsa/Midtown (Riverside Campus)	Tulsa	OK	44
Select Specialty Hospital	Central Pennsylvania (Camp Hill Campus)	Camp Hill	PA	31
Select Specialty Hospital	Danville	Danville	PA	30
Select Specialty Hospital	Erie	Erie	PA	50
Penn State Hershey Rehabilitation		Harrisburg	PA	32
Select Specialty Hospital	Johnstown	Johnstown	PA	39

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Hospital Name	City	State	Beds
Select Specialty Hospital Laurel Highlands	Latrobe	PA	40
Select Specialty Hospital McKeesport	McKeesport	PA	30
Select Specialty Hospital Pittsburgh	Pittsburgh	PA	32
Select Specialty Hospital Central Pennsylvania (York Campus)	York	PA	23
Select Specialty Hospital Central Pennsylvania (Harrisburg Campus)	Harrisburg	PA	38
Select Specialty Hospital Sioux Falls	Sioux Falls	SD	21
Select Specialty Hospital Tri-Cities	Bristol	TN	33
Select Specialty Hospital Knoxville	Knoxville	TN	35
Select Specialty Hospital North Knoxville	Knoxville	TN	33
Select Specialty Hospital Memphis	Memphis	TN	38
Select Specialty Hospital Nashville	Nashville	TN	47
Rehabilitation Institute of Denton, LLC	Denton	TX	44
Select Specialty Hospital Dallas/Ft Worth	Carrolton	TX	60
Select Specialty Hospital South Dallas	DeSoto	TX	100
Select Specialty Hospital Houston (Houston Heights)	Houston	TX	135
Select Specialty Hospital Houston (Houston Medical Center)	Houston	TX	79
Select Specialty Hospital Houston (Houston West)	Houston	TX	56
Select Specialty Hospital Longview	Longview	TX	30
Select Specialty Hospital Midland	Midland	TX	29
Select Specialty Hospital San Antonio	San Antonio	TX	44
Select Specialty Hospital Madison	Madison	WI	58
Select Specialty Hospital Milwaukee	Milwaukee	WI	34
Select Specialty Hospital Milwaukee (St Luke s Campus)	Milwaukee	WI	29
Select Specialty Hospital Charleston	Charleston	WV	32
Total Beds:			4,160

Legal Proceedings

We are subject to legal proceedings and claims that arise in the ordinary course of our business, which include malpractice claims covered under insurance policies, subject to self-insured retention of $2.0 million per medical incident for professional liability claims and $2.0 million per occurrence for general liability claims. In our opinion, the outcome of these actions will not have a material adverse effect on our financial position or results of operations. See Risk Factors Significant legal actions as well as the cost and possible lack of available insurance could subject us to substantial uninsured liabilities.

To cover claims arising out of the operations of our specialty hospitals and outpatient rehabilitation facilities, we maintain professional malpractice liability insurance and general liability insurance. We also maintain umbrella liability insurance covering claims which, due to their nature or amount, are not covered by or not fully covered by our other insurance policies. These insurance policies also do not generally cover punitive damages and are subject to various deductibles and policy limits. In addition, we review our insurance program annually and may make adjustments to the amount of insurance coverage and self-insured retentions in future years. Significant legal actions as well as the cost and possible lack of available insurance could subject us to substantial uninsured liabilities.

Health care providers are subject to lawsuits under the qui tam provisions of the federal False Claims Act. Qui tam lawsuits typically remain under seal (hence, usually unknown to the defendant) for some time while the

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government decides whether or not to intervene on behalf of a private qui tam plaintiff (known as a relator) and take the lead in the litigation. These lawsuits can involve significant monetary damages and penalties and award bounties to private plaintiffs who successfully bring the suits. We have been a defendant in these cases in the past, and may be named as a defendant in similar cases from time to time in the future.

During July 2009, we received a subpoena from the Office of Inspector General of the U.S. Department of Health and Human Services seeking various documents concerning our financial relationships with certain physicians practicing at our hospitals in Columbus, Ohio. We do not know whether the subpoena has been issued in connection with a qui tam lawsuit or in connection with possible civil, criminal or administrative proceedings by the government. We are assembling documents in order to respond to the subpoena and intend to fully cooperate with this investigation. At this time, we are unable to predict the timing and outcome of this matter.

Government Regulations

General

The healthcare industry is required to comply with many laws and regulations at the federal, state and local government levels. These laws and regulations require that hospitals and outpatient rehabilitation clinics meet various requirements, including those relating to the adequacy of medical care, equipment, personnel, operating policies and procedures, maintenance of adequate records, safeguarding protected health information, compliance with building codes and environmental protection and healthcare fraud and abuse. These laws and regulations are extremely complex and, in many instances, the industry does not have the benefit of significant regulatory or judicial interpretation. If we fail to comply with applicable laws and regulations, we could suffer civil or criminal penalties, including the loss of our licenses to operate and our ability to participate in the Medicare, Medicaid and other federal and state healthcare programs.

Licensure

Facility Licensure. Our healthcare facilities are subject to state and local licensing regulations ranging from the adequacy of medical care to compliance with building codes and environmental protection laws. In order to assure continued compliance with these various regulations, governmental and other authorities periodically inspect our facilities, not only at scheduled intervals but also in response to complaints from patients and others. While our facilities intend to comply with existing licensing, Medicare certification requirements and accreditation standards, there can be no assurance that regulatory authorities will determine that all applicable requirements are fully met at any given time. A determination by an applicable regulatory authority that a facility is not in compliance with these requirements could lead to the imposition of requirements that the facility takes corrective action, assessment of fines and penalties, or loss of licensure, Medicare certification or accreditation. These consequences could have an adverse effect on our company.

Some states still require us to get approval under certificate of need regulations when we create, acquire or expand our facilities or services, or alter the ownership of such facilities, whether directly or indirectly. The certificate of need regulations vary from state to state, and are subject to change and new interpretation. If we fail to show public need and obtain approval in these states for our new facilities or changes to the ownership structure of existing facilities, we may be subject to civil or even criminal penalties, lose our facility license or become ineligible for reimbursement.

Professional licensure and corporate practice. Healthcare professionals at our hospitals and outpatient rehabilitation clinics are required to be individually licensed or certified under applicable state law. We take steps to ensure that our employees and agents possess all necessary licenses and certifications.

Some states prohibit the corporate practice of therapy so that business corporations such as ours are restricted from practicing therapy through the direct employment of therapists. The laws relating to corporate practice vary from state to state and are not fully developed in each state in which we have clinics. We believe that each of our outpatient therapy clinics complies with any current corporate practice prohibition of the state in which it is located. For example, in those states that apply the corporate practice prohibition, we either contract to obtain therapy services from an entity permitted to employ therapists or we manage the physical therapy practice owned by

licensed therapists through which the therapy services are provided. However, future interpretations of the corporate practice prohibition, enactment of new legislation or adoption of new regulations could cause us to have to restructure our business operations or close our clinics in a particular state. If new legislation, regulations or interpretations establish that our clinics do not comply with state corporate practice prohibition, we could be subject to civil, and perhaps criminal, penalties. Any such restructuring or penalties could have a material adverse effect on our business.

Certification. In order to participate in the Medicare program and receive Medicare reimbursement, each facility must comply with the applicable regulations of the United States Department of Health and Human Services relating to, among other things, the type of facility, its equipment, its personnel and its standards of medical care, as well as compliance with all applicable state and local laws and regulations. All of our specialty hospitals participate in the Medicare program. In addition, we provide the majority of our outpatient rehabilitation services through clinics certified by Medicare as rehabilitation agencies or rehab agencies.

Accreditation. Our hospitals receive accreditation from The Joint Commission. As of June 30, 2009, The Joint Commission had fully accredited 91 of our 92 hospitals and partially accredited one hospital awaiting a full accreditation survey. Three of our five inpatient rehabilitation facilities have also received accreditation from the Commission on Accreditation of Rehabilitation Facilities, an independent, not-for-profit organization which reviews and grants accreditation for rehabilitation facilities that meet established standards for service and quality. Two of our inpatient rehabilitation facilities have not yet undergone a Commission on Accreditation of Rehabilitation Facilities survey.

Overview of U.S. and State Government Reimbursements

Medicare. The Medicare program reimburses healthcare providers for services furnished to Medicare beneficiaries, which are generally persons age 65 and older, those who are chronically disabled, and those suffering from end stage renal disease. The program is governed by the Social Security Act of 1965 and is administered primarily by the Department of Health and Human Services and CMS. Net operating revenues generated directly from the Medicare program represented approximately 53% of our consolidated net operating revenues for the year ended December 31, 2006, 48% for the year ended December 31, 2007, and 46% for the year ended December 31, 2008. For the six months ended June 30, 2009, we generated approximately 47% of our consolidated net operating revenues from Medicare.

The Medicare program reimburses various types of providers, including long term acute care hospitals, inpatient rehabilitation facilities and outpatient rehabilitation providers, using different payment methodologies. The Medicare reimbursement systems for long term acute care hospitals, inpatient rehabilitation facilities and outpatient rehabilitation providers, as described below, are different than the system applicable to general acute care hospitals. For general acute care hospitals, Medicare payments are made under an inpatient prospective payment system, or IPPS, under which a hospital receives a fixed payment amount per discharge (adjusted for area wage differences) using diagnosis-related groups, or DRGs. The general acute care hospital DRG payment rate is based upon the national average cost of treating a Medicare patient s condition in that type of facility. Although the average length of stay varies for each DRG, the average stay of all Medicare patients in a general acute care hospital is approximately six days. Thus, the prospective payment system for general acute care hospitals creates an economic incentive for those hospitals to discharge medically complex Medicare patients as soon as clinically possible. Effective October 1, 2005, CMS expanded its post-acute care transfer policy under which general acute care hospitals are paid on a per diem basis rather than the full DRG rate if a patient is discharged early to certain post-acute care settings, including LTCHs and IRFs. When a patient is discharged from selected DRGs to, among other providers, an LTCH, the general acute care hospital is reimbursed below the full DRG payment if the patient s length of stay is short relative to the geometric mean length of stay for the DRG. This policy originally applied to ten DRGs beginning in fiscal year 1999 and was expanded to additional DRGs in FY 2004 and a total of 182 DRGs effective October 1, 2005. The expansion of this policy to patients in a greater number of DRGs could cause general acute care hospitals to delay discharging

those patients to our long term acute care hospitals.

Long Term Acute Care Hospital Medicare Reimbursement. The Medicare payment system for long term acute care hospitals is based on a prospective payment system specifically applicable to LTCH. The long-term care

hospital prospective payment system, or LTCH-PPS was established by CMS final regulations, or final regulations, published on August 30, 2002 by CMS, and applies to long term acute care hospitals for their cost reporting periods beginning on or after October 1, 2002. Under LTCH-PPS, each patient discharged from a long term acute care hospital is assigned to a distinct LTC-DRG and a long term acute care hospital will generally be paid a pre-determined fixed amount applicable to the assigned LTC-DRG (adjusted for area wage differences). The payment amount for each LTC-DRG is intended to reflect the average cost of treating a Medicare patient assigned to that LTC-DRG in a long term acute care hospital. Cases with unusually high costs, referred to as high cost outliers, receive a payment adjustment to reflect the additional resources utilized. Conversely, cases with a stay that is considerably shorter than the average length of stay, a short-stay outlier, receive a reduction in payment. LTCH-PPS also includes special payment policies that adjust the payments for some patients based on the patient s length of stay, the facility s costs, whether the patient was discharged and readmitted and other factors. Congress required that the LTC-DRG payment rates maintain budget neutrality during the first years of the prospective payment system with total expenditures that would have been made under the previous reasonable cost-based payment system. The LTCH-PPS regulations permit CMS to make a one-time adjustment between December 29, 2010 and October 1, 2012 to correct any significant error CMS made in estimating the federal rate in the first year of LTCH-PPS.

The LTCH-PPS regulations also refined the criteria that must be met in order for a hospital to be certified as a long term acute care hospital. For cost reporting periods beginning on or after October 1, 2002, a long term acute care hospital must have an average inpatient length of stay for Medicare patients (including both Medicare covered and non-covered days) of greater than 25 days. Previously, average lengths of stay were measured with respect to all patients. LTCHs that fail to exceed an average length of stay of greater than 25 days during any cost reporting period will be paid under the general acute care hospital DRG-based reimbursement.

Prior to qualifying under the payment system applicable to long term acute care hospitals, a new long term acute care hospital initially receives payments under the general acute care hospital DRG-based reimbursement system. The long term acute care hospital must continue to be paid under this system for a minimum of six months while meeting certain Medicare long term acute care hospital requirements, the most significant requirement being an average Medicare length of stay of more than 25 days.

<u>August 2004 Final Rule</u>. On August 11, 2004, CMS published final regulations applicable to LTCHs that are operated as HIHs. Effective for hospital cost reporting periods beginning on or after October 1, 2004, subject to certain exceptions, the final regulations provide lower rates of reimbursement to HIHs for those Medicare patients admitted from their host hospitals that are in excess of a specified percentage threshold. For HIHs opened after October 1, 2004, the Medicare admissions threshold has been established at 25% except for HIHs located in rural areas or co-located with an MSA dominant hospital or single urban hospital where the percentage is no more than 50%, nor less than 25%.

For HIHs that meet specified criteria and were in existence as of October 1, 2004, including all but two of our then existing HIHs, the Medicare admissions thresholds are phased in over a four year period starting with hospital cost reporting periods that began on or after October 1, 2004. For discharges during the cost reporting period that began on or after October 1, 2005 and before October 1, 2006, the Medicare admissions threshold was the lesser of the Fiscal 2004 Percentage of Medicare discharges admitted from the host hospital or 75%. For discharges during the cost reporting period beginning on or after October 1, 2006 and before October 1, 2007, the Medicare admissions threshold was the lesser of the Fiscal 2004 Percentage of Medicare discharges admitted from the host hospital or 50%. For discharges during cost reporting periods beginning on or after October 1, 2007, the Medicare admissions threshold is 25%; however, the SCHIP Extension Act (as amended by the American Recovery and Reinvestment Act, the ARRA) generally limits the application of the Medicare admission threshold on HIHs in existence on October 1, 2004 and subject to the four year phase in described above for these HIHs, the admission threshold is no lower than 50% for a three year period to commence on an LTCHs first cost reporting period to begin on or after October 1, 2007. Under

the SCHIP Extension Act, for HIHs located in rural areas and those which receive referrals from MSA dominant hospitals or single urban hospitals (as defined by current regulations), the percentage threshold is no more than 75% during the same three cost reporting years. As used above, Fiscal 2004 Percentage means, with respect to any HIH, the percentage of all Medicare patients discharged by such HIH during its cost reporting period beginning on or after October 1, 2003 and before October 1, 2004 who were

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admitted to such HIH from its host hospital, but in no event is the Fiscal 2004 Percentage less than 25%. The HIH regulations also established exceptions to the Medicare admissions thresholds with respect to patients who reach outlier status at the host hospital, HIHs located in MSA dominant hospitals or HIHs located in rural areas.

In the 2008 rate year final rule, CMS applied the Medicare admissions threshold to admissions to grandfathered HIHs and grandfathered satellites from co-located hospitals. The SCHIP Extension Act delays application of the admissions threshold on grandfathered HIHs for a three year period commencing on the first cost reporting period beginning on or after July 1, 2007. The ARRA limits application of the admission threshold to no more than 50% of Medicare admissions to grandfathered satellites from a co-located hospital for a three year period commencing on the first cost reporting period beginning on or after July 1, 2007.

During the year ended December 31, 2007, we recorded a liability of approximately $5.9 million related to estimated repayments to Medicare for host admissions exceeding HIH s applicable admission threshold. The liability has been recorded through a reduction in our net revenue.

August 2005 Final Rule. On August 12, 2005, CMS published the final rules for general acute care hospitals IPPS, for fiscal year 2006, which included an update of the LTC-DRG relative weights. CMS estimated the changes to the relative weights would reduce LTCH Medicare payments-per-discharge by approximately 4.2% in fiscal year 2006 (the period from October 1, 2005 through September 30, 2006).

May 2006 Final Rule. On May 12, 2006, CMS published its final annual payment rate updates for the 2007 LTCH-PPS rate year (affecting discharges and cost reporting periods beginning on or after July 1, 2006 and before July 1, 2007), or RY 2007. The May 2006 final rule revised the payment adjustment formula for short stay outlier, or SSO, patients. For discharges occurring on or after July 1, 2006, the rule changed the payment methodology for Medicare patients with a length of stay less than or equal to five-sixths of the geometric average length of stay for each SSO case. Payment for these patients had been based on the lesser of (1) 120% of the cost of the case; (2) 120% of the LTC-DRG specific per diem amount multiplied by the patient s length of stay; or (3) the full LTC-DRG payment. The May 2006 final rule modified the limitation in clause (1) above to reduce payment for SSO cases to 100% (rather than 120%) of the cost of the case. The final rule also added a fourth limitation, capping payment for SSO cases at a per diem rate derived from blending 120% of the LTC-DRG specific per diem amount with a per diem rate based on the general acute care hospital IPPS. Under this methodology, as a patient s length of stay increases, the percentage of the per diem amount based upon the IPPS component will decrease and the percentage based on the LTC-DRG component will increase.

In addition, for discharges occurring on or after July 1, 2006, the May 2006 final rule provided for (1) a zero-percent update to the LTCH-PPS standard federal rate used as a basis for LTCH-PPS payments for the 2007 LTCH-PPS rate year; (2) the elimination of the surgical case exception to the three day or less interruption of stay policy (under the surgical exception, Medicare reimburses a general acute care hospital directly for surgical services furnished to a long term acute care hospital patient during a brief interruption of stay from the long term acute care hospital, rather than requiring the long term acute care hospital to bear responsibility for such surgical services); and (3) increasing the costs that a long term acute care hospital must bear before Medicare will make additional payments for a case under its high-cost outlier policy for RY 2007.

CMS estimated that the changes in the May 2006 final rule would result in an approximately 3.7% decrease in LTCH Medicare payments-per-discharge compared to the 2006 rate year, largely attributable to the revised SSO payment methodology. We estimated that the May 2006 final rule reduced Medicare revenues associated with SSO cases and high-cost outlier cases to our long term acute care hospitals by approximately $29.3 million for RY 2007.

Additionally, had CMS updated the LTCH-PPS standard federal rate by the 2007 estimated market basket index of 3.4% rather than applying the zero-percent update, we estimated that we would have received approximately $31.0 million in additional annual Medicare revenues based on our historical Medicare patient volumes and revenues (such revenues would have been paid to our hospitals for discharges beginning on or after July 1, 2006).

August 2006 Final Rule. On August 18, 2006, CMS published the IPPS final rule for fiscal year 2007, which is the period from October 1, 2006 through September 30, 2007, that included an update of the LTC-DRG relative weights for fiscal year 2007. CMS estimated the changes to the relative weights would reduce LTCH Medicare payments-per-discharge by approximately 1.3% in fiscal year 2007. The August 2006 final rule also included changes

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to the DRGs in IPPS that apply to LTCHs, as the LTC-DRGs are based on the IPPS DRGs. CMS created 20 new DRGs and modified 32 others, including LTC-DRGs. Prior to the August 2006 final rule, certain HIHs that were in existence on or before September 30, 1995, and certain satellite facilities that were in existence on or before September 30, 1999, referred to as grandfathered HIHs or satellites, were not subject to certain HIH separateness and control requirements as long as the grandfathered HIHs or satellites continued to operate under the same terms and conditions, including the number of beds and square footage, in effect on September 30, 2003 (for grandfathered HIHs) or September 30, 1999 (for grandfathered satellites). These grandfathered HIHs were also not subject to the payment adjustments for discharged Medicare patients admitted from their host hospitals in excess of the specified percentage threshold, as discussed in the August 2004 rule above. The August 2006 final rule revised the regulations to provide grandfathered HIHs more flexibility in adjusting square footage upward or downward, or decreasing the number of beds without being subject to the separateness and control requirements and payment adjustment provisions. As of June 30, 2009, we operated three grandfathered HIHs.

May 2007 Final Rule. On May 1, 2007, CMS published its annual payment rate update for the 2008 LTCH-PPS rate year, or RY 2008 (affecting discharges and cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008). The May 2007 final rule makes several changes to LTCH-PPS payment methodologies and amounts during RY 2008 although, as described below, many of these changes have been postponed for a three year period by the SCHIP Extension Act.

For cost reporting periods beginning on or after July 1, 2007, the May 2007 final rule expanded the current Medicare admissions threshold to apply to Medicare patients admitted from any individual hospital. Previously, the admissions threshold was applicable only to Medicare admissions from hospitals co-located with an LTCH or satellite of an LTCH. Under the May 2007 final rule, free-standing LTCHs and grandfathered HIHs are subject to the Medicare admission thresholds, as well as HIHs that admit Medicare patients from non-co-located hospitals. To the extent that any LTCH s or LTCH satellite facility s discharges that are admitted from an individual hospital (regardless of whether the referring hospital is co-located with the LTCH or LTCH satellite) exceed the applicable percentage threshold during a particular cost reporting period, the payment rate for those discharges would be subject to a downward payment adjustment. Cases admitted in excess of the applicable threshold would be reimbursed at a rate comparable to that under general acute care IPPS, which is generally lower than LTCH-PPS rates. Cases that reach outlier status in the discharging hospital would not count toward the limit and would be paid under LTCH-PPS. CMS estimated the impact of the expansion of the Medicare admission thresholds would result in a reduction of 2.2% of the aggregate payments to all LTCHs in RY 2008.

The applicable percentage threshold is generally 25% after the completion of the phase-in period described below. The percentage threshold for LTCH discharges from a referring hospital that is an MSA dominant hospital or a single urban hospital is the percentage of total Medicare discharges in the MSA that are from the referring hospital, but no less than 25% nor more than 50%. For Medicare discharges from LTCHs or LTCH satellites located in rural areas, as defined by the Office of Management and Budget, the percentage threshold is 50% from any individual referring hospital. The expanded 25% rule is being phased in over a three year period. The three year transition period starts with cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008, when the threshold is the lesser of 75% or the percentage of the LTCH s or LTCH satellite s admissions discharged from the referring hospital during its cost reporting period beginning on or after July 1, 2004 and before July 1, 2005, or RY 2005. For cost reporting periods beginning on or after July 1, 2008 and before July 1, 2009, the threshold will be the lesser of 50% or the percentage of the LTCH s or LTCH satellite s admissions from the referring hospital, during its RY 2005 cost reporting period. For cost reporting periods beginning on or after July 1, 2009, all LTCHs will be subject to the 25% threshold (or applicable threshold for rural, urban-single, or MSA dominant hospitals). The SCHIP Extension Act, as amended by the ARRA, postponed the application of the percentage threshold to all free-standing and grandfathered HIHs for a three year period commencing on an LTCH s first cost reporting period on or after July 1, 2007. However, the SCHIP Extension Act did not postpone the application of the percentage threshold, or the transition period stated above, to

those Medicare patients discharged from an LTCH HIH or satellite that were admitted from a non-co-located hospital.

The May 2007 final rule further revised the payment adjustment formula for SSO cases. Beginning with discharges on or after July 1, 2007, for cases with a length of stay that is less than the average length of stay plus one standard deviation for the same DRG under IPPS, referred to as the so-called IPPS comparable threshold, the rule

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effectively lowers the LTCH payment to a rate based on the general acute care hospital IPPS. SSO cases with covered lengths of stay that exceed the IPPS comparable threshold would continue to be paid under the SSO payment policy described above under the May 2006 final rule. Cases with a covered length of stay less than or equal to the IPPS comparable threshold and less than five-sixths of the geometric average length of stay for that LTC-DRG would be paid at an amount comparable to the IPPS per diem. The SCHIP Extension Act also postpones, for the three year period beginning on December 29, 2007, the SSO policy changes made in the May 2007 final rule.

The May 2007 final rule increased the standard federal rate by 0.71% for RY 2008. As a result, the federal rate for RY 2008 increased to $38,356.45 from $38,086.04 for RY 2007. Subsequently, the SCHIP Extension Act eliminated the update to the standard federal rate that occurred for RY 2008 effective April 1, 2008. This adjustment to the standard federal rate was applied prospectively on April 1, 2008 and reduced the federal rate back to $38,086.04. In a technical correction to the May 2007 final rule, CMS increased the fixed-loss amount for high cost outlier in RY 2008 to $20,738 from $14,887 in RY 2007. CMS projected an estimated 0.4% decrease in LTCH payments in RY 2008 due to this change in the fixed-loss amount and the overall impact of the May 2007 final rule to be a 1.2% decrease in total estimated LTCH PPS payments for RY 2008.

The May 2007 final rule provided that beginning with the annual payment rate updates to the LTC-DRG classifications and relative weights for the fiscal year 2008, or FY 2008 (affecting discharges beginning on or after October 1, 2007 and before September 30, 2008), annual updates to the LTC-DRG classification and relative weights are to have a budget neutral impact. Under the May 2007 final rule, future LTC-DRG reclassification and recalibrations, by themselves, should neither increase nor decrease the estimated aggregated LTCH PPS payments.

The May 2007 final rules are complex and the SCHIP Extension Act has postponed the implementation of certain of the May 2007 final rules. While we cannot predict the ultimate long term impact of LTCH PPS because the payment system remains subject to significant change, if the May 2007 final rules become effective as currently written, after the expiration of the applicable provisions of SCHIP Extension Act, our future net operating revenues and profitability will be adversely affected.

August 2007 Final Rule. On August 22, 2007, CMS published the IPPS final rule for FY 2008, which created a new patient classification system with categories referred to as MS-DRGs and MS-LTC-DRGs, respectively, for hospitals reimbursed under IPPS and LTCH PPS. Beginning with discharges on or after October 1, 2007, the new classification categories take into account the severity of the patient s condition. CMS assigned proposed relative weights to each MS-DRG and MS-LTC-DRG to reflect their relative use of medical care resources. We believe that, because of the proposed relative weights and length of stay assigned to the MS-LTC-DRGs for the patient populations served by our hospitals, our long term acute care hospital payments may be adversely affected.

The August 2007 final rule published a budget neutral update to the MS-LTC-DRG classification and relative weights. In the preamble to the IPPS final rule for FY 2008 CMS restated that it intends to continue to update the LTC-DRG weights annually in the IPPS rulemaking and those weights would be modified by a budget neutrality adjustment factor to ensure that estimated aggregate LTCH payments after reweighting are equal to estimated aggregate LTCH payments before reweighting.

Medicare, Medicaid and SCHIP Extension Act of 2007. On December 29, 2007, the President signed into law the SCHIP Extension Act. Among other changes in the federal health care programs, the SCHIP Extension Act makes significant changes to Medicare policy for LTCHs including a new statutory definition of an LTCH, a report to Congress on new LTCH patient criteria, relief from certain LTCH-PPS payment policies for three years, a three year moratorium on the establishment and classification of new LTCHs and LTCH beds, elimination of the payment update for the last quarter of RY 2008 and new medical necessity reviews by Medicare contractors through at least October 1, 2010.

Previously, the statutory definition of an LTCH focused on the facility having an average length of stay of greater than 25 days. The SCHIP Extension Act adds to the statutory requirements by defining an LTCH as a hospital primarily engaged in providing inpatient services to Medicare beneficiaries with medically complex conditions that require a long hospital stay. In addition, by definition, LTCHs must meet certain facility criteria, including (1) instituting a review process that screens patients for appropriateness of an admission and validates the patient criteria within 48 hours of each patient s subsequent admission, evaluates regularly their patients for continuation of care and assesses the available

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discharge options; (2) having active physician involvement with patient care that includes a physician available on-site daily and additional consulting physicians on call; and (3) having an interdisciplinary team of health care professionals to prepare and carry out an individualized treatment plan for each patient. We do not expect that these changes will have any impact on the designation of our hospitals as LTCHs.

The SCHIP Extension Act requires the Secretary of the Department of Health and Human Services to conduct a study on the establishment of national LTCH facility and patient criteria for the purpose of determining medical necessity, appropriateness of admissions and continued stay at, and discharge from, LTCHs. The Secretary must submit a report on the results of this study to Congress within 18 months following enactment of the SCHIP Extension Act. Both the study and the report are required to consider recommendations on LTCH-specific facility and patient criteria contained in a June 2004 report to Congress by the Medicare Payment Advisory Commission.

As described above, the SCHIP Extension Act precludes the Secretary from implementing, during the three year moratorium period, the provisions added by the May 2007 final rule that extended the 25% rule to free-standing LTCHs and grandfathered HIHs. The SCHIP Extension Act also modifies, during the moratorium, the effect of the 25% rule for non-grandfathered LTCH HIHs, non-grandfathered satellites and grandfathered LTCH HIHs, as it applies to admissions from co-located hospitals. For HIHs, the applicable percentage threshold is set at 50%. For HIHs located in rural areas and those which receive referrals from MSA dominant hospitals or single urban hospitals, the percentage threshold is set at no more than 75%. The ARRA further revises the SCHIP Extension Act to postpone the percentage limitations established in the SCHIP Extension Act to the three cost reporting periods beginning on or after July 1, 2007 for freestanding LTCHs, grandfathered HIHs, and grandfathered satellites and on or after October 1, 2007 for non-grandfathered LTCH HIHs and non-grandfathered satellites.

The SCHIP Extension Act also precludes the Secretary from implementing, for the three year period beginning on December 29, 2007, a one-time adjustment to the LTCH standard federal rate. This rule, established in the original LTCH-PPS regulations, permits CMS to restate the standard federal rate to reflect the effect of changes in coding since the LTCH-PPS base year. In the preamble to the May 2007 final rule, CMS discussed making a one-time prospective adjustment to the LTCH-PPS rates for the 2009 rate year. In addition, the SCHIP Extension Act reduced the Medicare payment update for the portion of RY 2008 from April 1, 2008 to June 30, 2008 to the same base rate applied to LTCH discharges during RY 2007.

For the three calendar years following December 29, 2007, the Secretary must impose a moratorium on the establishment and classification of new LTCHs, LTCH satellite facilities, and LTCH beds in existing LTCH or satellite facilities. This moratorium does not apply to LTCHs that, before the date of enactment, (1) began the qualifying period for payment under the LTCH-PPS, (2) have a written agreement with an unrelated party for the construction, renovation, lease or demolition for a LTCH and have expended at least 10% of the estimated cost of the project or $2,500,000, or (3) have obtained an approved certificate of need. Additionally, an LTCH located in a state with only two LTCHs, may request an increase in licensed beds following the closure or decrease in the number of licensed beds at the other LTCH located within the state. As a result of the SCHIP Extension Act s three calendar year moratorium on the development of new LTCHs, we have stopped all LTCH development, except for LTCHs currently under construction that are excluded from the moratorium.

Beginning with LTCH discharges on or after October 1, 2007 and through September 30, 2010 (unless extended by the Secretary), the SCHIP Extension Act also requires the Secretary to significantly expand medical necessity review for patients admitted to LTCHs by instituting a review of the medical necessity of continued stays of patients admitted to LTCHs. The medical necessity reviews must include a representative sample that results in a 95% confidence interval and guarantees that at least 75% of overpayments received by LTCHs for medically unnecessary admissions and continued stays are recovered and not counted toward an LTCH s Medicare average length of stay. The Secretary may use up to 40% of the recouped overpayments to compensate the fiscal intermediaries and Medicare

administrative contractors for the costs of conducting medical necessity reviews.

May 6, 2008 Interim Final Rule. On May 6, 2008, CMS published an interim final rule with comment period, which implemented portions of the SCHIP Extension Act. The May 6, 2008 interim final rule addressed: (1) the payment adjustment for very short-stay outliers, (2) the standard federal rate for the last three months of RY 2008, (3) adjustment of the high cost outlier fixed-loss amount for the last three months of RY 2008, and (4) made reference to the SCHIP Extension Act in the discussion of the basis and scope of the LTCH-PPS rules.

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As provided in the SCHIP Extension Act, for discharges beginning on or after December 29, 2007 and before December 29, 2010, the RY 2008 short-stay outlier rule based on the IPPS comparable threshold does not apply. The RY 2008 rule required that cases with a covered length of stay less than or equal to the IPPS comparable threshold and less than five-sixths of the geometric average length of stay for that DRG were paid at an amount comparable to the IPPS per diem. IPPS comparable threshold is defined as cases with a length of stay that is less than the average length of stay plus one standard deviation for the same DRG under IPPS. For discharges occurring on or after April 1, 2008 through June 30, 2008, the revised RY 2008 standard federal rate is $38,086.04, which is the same as the RY 2007 federal rate. In the only interpretation of the SCHIP Extension Act in the interim rule, CMS states that it is interpreting the term base rate to be the standard federal rate because we believe Congress meant to eliminate the 0.71% update from the RY 2008 standard federal rate. Finally, the revised high cost outlier fixed-loss amount for discharges occurring on or after April 1, 2008 through June 30, 2008 is $20,707, a decrease of $31 per discharge from the $20,738 fixed-loss amount established by CMS in its technical correction to the May 2007 final rule. CMS indicates that the other issues addressed in the SCHIP Extension Act will be discussed in a forthcoming regulation, including instructions concerning (1) the moratorium on the certification of new LTCHs and satellites and the expansion of beds in existing facilities and (2) implementing changes to the 25% admission threshold adjustment for LTCH patients admitted from certain referring hospitals for a three year period.

May 9, 2008 Final Rule. On May 9, 2008, CMS published its annual payment rate update for the 2009 LTCH-PPS rate year, or RY 2009 (affecting discharges and cost reporting periods beginning on or after July 1, 2008). The final rule adopts a 15-month rate update, from July 1, 2008 through September 30, 2009 and moves LTCH-PPS from a July-June update cycle to the same update cycle as the general acute care hospital inpatient rule (October September). For RY 2009, the rule establishes a 2.7% update to the standard federal rate. The rule increases the fixed-loss amount for high cost outlier cases to $22,960, which is $2,222 higher than the 2008 LTCH-PPS rate year. The final rule provides that CMS may make a one-time reduction in the LTCH-PPS rates to reflect a budget neutrality adjustment no earlier than December 29, 2010 and no later than October 1, 2012. CMS estimated this reduction will be approximately 3.75%.

May 22, 2008 Interim Final Rule. On May 22, 2008, CMS published an interim final rule with comment period, which implements portions of the SCHIP Extension Act not addressed in the May 6, 2008 interim final rule. Among other things, the May 22, 2008 interim final rule establishes a definition for free-standing LTCHs as a hospital that: (1) has a Medicare provider agreement, (2) has an average length of stay of greater than 25 days, (3) does not occupy space in a building used by another hospital, (4) does not occupy space in one or more separate or entire buildings located on the same campus as buildings used by another hospital; and (5) is not part of a hospital that provides inpatient services in a building also used by another hospital. As required by the SCHIP Extension Act, CMS made certain changes to the payment adjustment policy in the May 22, 2008 interim final rule. Effective for cost reporting periods beginning on or after December 29, 2007 and before December 29, 2010, CMS delayed the extension of the 25% threshold payment adjustment to grandfathered HIHs and free-standing LTCHs. Furthermore, CMS increased the patient percentage thresholds from 25% to 50% for certain LTCH HIH and satellite discharges admitted from a co-located hospital, and from 50% to 75% for certain LTCH HIH and satellite discharges at rural HIHs or admitted from a co-located MSA dominant or urban single hospital. For purposes of LTCH HIH and satellite discharges admitted from a co-located MSA dominant or urban single hospital, the percentage threshold continues to be limited by the percentage of total Medicare discharges in the MSA in which the hospital is located that are from the co-located hospital.

The May 22, 2008 interim final rule, effective December 29, 2007, continues to apply the percentage threshold to grandfathered satellites for patients admitted from any individual hospital with which they are not co-located. In addition, LTCH HIHs and LTCH satellites that are not grandfathered remain subject to the percentage threshold for patients admitted from non-co-located hospitals. Neither the SCHIP Extension Act nor the ARRA delayed or excluded these facilities from the percentage threshold applicable for cost reporting periods beginning on or after July 1, 2007.

For LTCHs subject to the expanded percentage threshold a three year transition period starts with cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008, when the threshold is the lesser of 75% or the percentage of the LTCH s or LTCH satellite s admissions discharged from the referring hospital during its cost reporting period beginning on or after July 1, 2004 and before July 1, 2005 (RY 2005). For cost reporting periods beginning on or after July 1, 2008 and before July 1, 2009, the threshold will be the lesser of 50% or the

percentage of the LTCH s or LTCH satellite s admissions from the referring hospital, during its RY 2005 cost reporting period. For cost reporting periods beginning on or after July 1, 2009, LTCHs subject to the expanded percentage threshold will be subject to the 25% threshold (or applicable threshold for rural, urban-single, or MSA dominant hospitals).

In accordance with the SCHIP Extension Act, the May 22, 2008 interim final rule provides an exception for new LTCHs that, on or before December 29, 2007, (1) began the qualifying period for payment under the LTCH PPS, (2) have a binding written agreement with an unrelated party for the construction, renovation, lease or demolition for a LTCH and have expended at least 10% of the estimated cost of the project or $2,500,000, or (3) have obtained an approved certificate of need. The May 22, 2008 interim final rule implements a moratorium on any increase of LTCH beds in existing LTCHs or LTCH satellites beginning on December 29, 2007 and continuing through December 28, 2010. CMS interprets the moratorium on new beds to apply only to the number of Medicare-certified beds at the hospital at the beginning of the moratorium period. The May 22, 2008 interim final rule also implements a narrow exception for new beds. LTCHs located in a state with only two LTCHs may request an increase in Medicare-certified beds following the closure or decrease in the number of beds at the other LTCH located within the state. CMS noted that the exception for an increase in beds does not apply to the limit on the number of beds in grandfathered LTCH HIHs or grandfathered LTCH satellites. A grandfathered facility would not be allowed to maintain its grandfathered status if it increases its number of beds under the exception.

August 2008 Final Rule. On August 19, 2008, CMS published the IPPS final rule for FY 2009 (affecting discharges and cost reports beginning on or after October 1, 2008 and before October 1, 2009), which made limited revisions to the classifications of cases in Medicare severity long term care diagnosis-related groups (MS-LTC-DRGs). The final rule also includes a number of hospital ownership and physician referral provisions, including a proposal to expand a hospital s disclosure obligations by requiring physician-owned hospitals to disclose ownership or investment interests held by immediate family members of a referring physician. The final rule requires physician-owned hospitals to furnish to patients, on request, a list of physicians or immediate family members who own or invest in the hospital. Moreover, a physician-owned hospital must require all physician owners or investors who are also active members of the hospital s medical staff to disclose in writing their ownership or investment interests in the hospital to all patients they refer to the hospital. CMS can terminate the Medicare provider agreement of a physician-owned hospital if it fails to comply with these disclosure provisions or with the requirement that a hospital disclose in writing to all patients whether there is a physician on-site at the hospital 24 hours per day, seven days per week.

Because the LTCH-PPS rules are complex and are based, in part, on the volume of Medicare admissions from our host hospitals and free-standing hospitals as a percent of our overall Medicare admissions, we cannot predict with any certainty the impact on our future net operating revenues of compliance with these regulations. However, we expect the financial impact to increase as the Medicare admissions thresholds decline during the phase-in of the regulations.

The American Recovery and Reinvestment Act of 2009. On February 17, 2009, President Obama signed into law the ARRA. The ARRA makes several technical corrections to the SCHIP Extension Act, including a clarification that, during the moratorium period established by the SCHIP Extension Act, the percentage threshold for grandfathered satellites is set at 50% and not phased in to the 25% level for admissions from a co-located hospital. In addition, the ARRA clarifies that the application of the percentage threshold is postponed for a LTCH HIH or satellite that was co-located with a provider-based, off-campus location of an IPPS hospital that did not deliver services payable under IPPS. The ARRA also provides that the postponement of the percentage limitations established in the SCHIP Extension Act will be effective for cost reporting periods beginning on or after July 1, 2007 for freestanding LTCHs and grandfathered HIHs and on or after October 1, 2007 for other LTCH HIHs.

June 3, 2009 Interim Final Rule. On June 3, 2009, CMS published an interim final rule in which CMS adopts a new table of MS-LTC-DRG relative weights that will apply from June 3, 2009 to the remainder of fiscal year 2009

(through September 30, 2009). This interim final rule revises the MS-LTC-DRG relative weights for payment under the LTCH-PPS for fiscal year 2009 due to CMS s misapplication of its established methodology in the calculation of the budget neutrality factor. CMS states that the calculation of the budget neutrality factor of 1.04186 was determined using the unadjusted recalibrated relative weights rather than using the normalized relative weights. The revised fiscal year 2009 budget neutrality factor is 1.0030401. This error resulted in relative weights that are higher,

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by approximately 3.9 percent for all of fiscal year 2009 (October 1, 2008 through September 30, 2009). However, CMS is only applying the corrected weights to the remainder of fiscal year 2009 (that is, from June 3, 2009 through September 30, 2009).

June 3, 2009 Supplement to May 2009 Proposed Rule. On June 3, 2009, CMS published a supplement to the proposed rule previously published on May 1, 2009. The supplemental proposed rule updates the rate year 2010 LTCH-PPS payments by revising the table of MS-LTC-DRG relative weights for rate year 2010, which is based on the amended fiscal year 2009 weights. The supplemental proposed rule presents both proposed rate year 2010 MS-LTC-DRG relative weights and a proposed rate year 2010 high cost outlier fixed-loss amount based on the revised fiscal year 2009 MS-LTC-DRG relative weights presented in the interim final rule with comment period discussed above. The supplemental proposed rule updates the rate year 2010 MS-LTC-DRG relative weights based upon the application of the proposed rate year 2010 normalization factor of 1.07264 and the proposed rate year 2010 budget neutrality factor 0.993343. In the proposed rule published on May 1, 2009 for the rate year 2010 LTCH PPS, CMS proposed a fixed-loss amount of $16,059 for rate year 2010, which is a decrease from $22,960 in the 2009 rate year. The supplemental proposed rule would change the fixed-loss amount to $18,868 for rate year 2010. CMS estimates that the changes related to the supplemental proposed rule will result in a 2.2% increase to the average Medicare payments to LTCHs for fiscal 2010, which is 0.6% lower than proposed in the original May 1, 2009 proposed rule.

July 31, 2009 Final Rule. On July 31, 2009, CMS released its annual payment rate update for the 2010 LTCH PPS rate year, or RY 2010 (affecting discharges and cost reporting periods beginning on or after October 1, 2009 and before September 30, 2010). For RY 2010 CMS adopted a 2.5% increase in payments under the LTCH PPS. As a result, the standard federal rate for RY 2010 is set at $39,896.65, an increase from $39,114.36 in RY 2009. The increase in the standard federal rate uses a 2% update factor based on the market basket update of 2.5% less an adjustment of 0.5% to account for changes in documentation and coding practices. The fixed loss amount for high cost outlier cases is set at $18,425. This is a decrease from the fixed-loss amount in the 2009 rate year of $22,960.

The July 31, 2009 annual payment rate update also included an interim final rule implementing provisions of the ARRA discussed above, including amendments to provisions of the SCHIP Extension Act relating to payments to LTCHs and LTCH satellite facilities and increases in beds in existing LTCHs and LTCH satellite facilities under the LTCH PPS.

On July 31, 2009, CMS finalized three interim final rules with comment period that it previously published but had yet to respond to public comment. First, CMS finalized the June 3, 2009 interim final rule that adopted a new table of MS-LTC-DRG relative weights for the period between June 3, 2009 and September 30, 2009. Second, CMS finalized the May 6 2008 interim final rule that implemented changes to LTCH PPS mandated by the SCHIP Extension Act addressing: (1) payment adjustments for certain short-stay outliers , (2) the federal standard rate for the last three months of rate year 2008, and (3) adjustment of the high cost outlier fixed-loss amount. Finally, CMS finalized the May 22, 2008 interim final rule that implemented changes to LTCH PPS mandated by the SCHIP Extension Act modifying the percentage threshold policy for certain LTCHs and addressing the three-year moratorium on the establishment of new LTCHs and bed increases at existing LTCHs and LTCH satellites.

Medicare Reimbursement of Outpatient Rehabilitation Services. Beginning on January 1, 1999, the Balanced Budget Act of 1997 subjected certain outpatient therapy providers reimbursed under the Medicare physician fee schedule to annual limits for therapy expenses. Effective January 1, 2008, the annual limit on outpatient therapy services is $1,810 for combined physical and speech language pathology services and $1,810 for occupational therapy services. In the Deficit Reduction Act of 2005, Congress implemented an exceptions process to the annual limit for therapy expenses. Under this process, a Medicare enrollee (or person acting on behalf of the Medicare enrollee) is able to request an exception from the therapy caps if the provision of therapy services was deemed to be medically necessary. Therapy cap exceptions were available automatically for certain conditions and on a case-by-case basis upon submission of

documentation of medical necessity. The SCHIP Extension Act extended the cap exceptions process through June 30, 2008. The Medicare Improvements for Patients and Providers Act of 2008 further extended the cap exceptions process through December 31, 2009. CMS released the final rule for the 2009 Medicare physician fee schedule on October 30, 2008. The final rule increases the annual per beneficiary cap on outpatient therapy services for 2009 to $1,840 for combined physical therapy and speech language pathology services and $1,840 for occupational therapy services. The per beneficiary caps were $1,810 for calendar year 2008. The final rule also

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extends the exiting therapy cap exceptions process through December 31, 2009 as authorized by Congress, updates the conversion factor, and makes adjustments to the relative value units. Prior to implementing the exceptions process to the therapy caps, only hospitals could bill for outpatient rehabilitation services that exceeded the annual caps. Elimination of the therapy cap exceptions may reduce our future net operating revenues and profitability.

Historically, outpatient rehabilitation services have been subject to scrutiny by the Medicare program for, among other things, medical necessity for services, appropriate documentation for services, supervision of therapy aides and students and billing for group therapy. CMS has issued guidance to clarify that services performed by a student are not reimbursed even if provided under line of sight supervision of the therapist. Likewise, CMS has reiterated that Medicare does not pay for services provided by aides regardless of the level of supervision. CMS also has issued instructions that outpatient physical and occupational therapy services provided simultaneously to two or more individuals by a practitioner should be billed as group therapy services.

Medicare Reimbursement of Inpatient Rehabilitation Facility Services. Inpatient rehabilitation facilities are paid under a prospective payment system specifically applicable to this provider type, which is referred to as IRF-PPS. Under the IRF-PPS, each patient discharged from an inpatient rehabilitation facility is assigned to a case mix group or IRF-CMG containing patients with similar clinical problems that are expected to require similar amounts of resources. An inpatient rehabilitation facility is generally paid a pre-determined fixed amount applicable to the assigned IRF-CMG (subject to applicable case adjustments related to length of stay and facility level adjustments for location and low income patients). The payment amount for each IRF-CMG is intended to reflect the average cost of treating a Medicare patient s condition in an inpatient rehabilitation facility relative to patients with conditions described by other IRF-CMGs. The IRF-PPS also includes special payment policies that adjust the payments for some patients based on the patient s length of stay, the facility s costs, whether the patient was discharged and readmitted and other factors. As required by Congress, IRF-CMG payments rates have been set to maintain budget neutrality with total expenditures that would have been made under the previous reasonable cost based system. The IRF-PPS was phased in over a transition period in 2002. For cost reporting periods beginning on or after October 1, 2002, inpatient rehabilitation facilities are paid solely on the basis of the IRF-PPS payment rate.

Although the initial IRF-PPS regulations did not change the criteria that must be met in order for a hospital to be certified as an inpatient rehabilitation facility, CMS adopted a separate final rule on May 7, 2004 that made significant changes to those criteria. The new inpatient rehabilitation facility certification criteria became effective for cost reporting periods beginning on or after July 1, 2004. Under the historic IRF certification criteria that had been in effect since 1983, in order to qualify as an IRF, a hospital was required to satisfy certain operational criteria as well as demonstrate that, during its most recent 12-month cost reporting period, it served an inpatient population of whom at least 75% required intensive rehabilitation services for one or more of ten conditions specified in the regulation. We refer to such 75% requirement as the 75% test.

CMS adopted four major changes to the 75% test in its May 7, 2004 final rule. First, CMS temporarily lowered the 75% compliance threshold, as follows: (1) 50% for cost reporting periods beginning on or after July 1, 2004 and before July 1, 2005; (2) 60% for cost reporting periods beginning on or after July 1, 2005 and before July 1, 2006; (3) 65% for cost reporting periods beginning on or after July 1, 2006 and before July 1, 2007; and (4) 75% for cost reporting periods beginning on or after July 1, 2007. Second, CMS modified and expanded from ten to 13 the medical conditions used to determine whether a hospital qualifies as an inpatient rehabilitation facility. Third, the agency finalized the conditions under which comorbidities can be used to verify compliance with the 75% test. Fourth, CMS changed the timeframe used to determine compliance with the 75% test from the most recent 12-month cost reporting period to the most recent, consecutive, and appropriate 12-month period, with the result that a determination of non-compliance with the applicable compliance threshold will affect the facility s certification for its cost reporting period that begins immediately after the 12-month review period.

Under the Deficit Reduction Act of 2005, enacted on February 8, 2006, Congress extended the phase-in period for the 75% test by maintaining the compliance threshold at 60% (rather than increasing it to 65%) during the 12-month period beginning on July 1, 2006. The compliance threshold then increases to 65% for cost reporting periods beginning on or after July 1, 2007 and again to 75% for cost reporting periods beginning on or after July 1, 2008.

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August 2006 Final Rule. In the August 2006 final rule updating IRF-PPS for discharges occurring on or after October 1, 2006 and on or before September 30, 2007, CMS reduced the standard payment amount by 2.6% and increased the outlier threshold for fiscal year 2007 to $5,534 from $5,129 for fiscal year 2006. CMS stated that the reduction in standard payment was to account for coding changes that did not reflect real changes in case mix.

August 2007 Final Rule. In the August 2007 final rule updating IRF-PPS for discharges occurring on or after October 1, 2007 and on or before September 30, 2008, CMS increased the standard payment amount by 3.2% and increased the outlier threshold for fiscal year 2008 to $7,362 from $5,534 for fiscal year 2007.

Medicare Medicaid and SCHIP Extension Act of 2007. The SCHIP Extension Act includes a permanent freeze in the patient classification criteria compliance threshold at 60% (with comorbidities counting toward this threshold) and a payment freeze from April 1, 2008 through September 30, 2009. In order to comply with Medicare inpatient rehabilitation facility certification criteria, it may be necessary for our IRFs to implement restrictive admissions policies and not admit patients whose diagnoses fall outside the 13 specified conditions. Such policies may result in reduced patient volumes, which could have a negative effect on financial performance.

In addition to meeting the compliance threshold, a hospital must meet other facility criteria to be classified as an IRF, including: (1) a provider agreement to participate as a hospital in Medicare; (2) a preadmission screening procedure; (3) ensuring that patients receive close medical supervision and furnish, through the use of qualified personnel, rehabilitation nursing, physical therapy, and occupational therapy, plus, as needed, speech therapy, social or psychological services, and orthotic and prosthetic services; (4) a full-time, qualified director of rehabilitation; (5) a plan of treatment for each inpatient that is established, reviewed, and revised as needed by a physician in consultation with other professional personnel who provide services to the patient; (6) a coordinated multidisciplinary team approach in the rehabilitation of each inpatient, as documented by periodic clinical entries made in the patient s medical record to note the patient s status in relationship to goal attainment, and that team conferences are held at least every two weeks to determine the appropriateness of treatment. Failure to comply with any of the classification criteria, including the compliance threshold, may cause a hospital to lose its exclusion from the prospective payment system that applies to general acute care hospitals and, as a result, no longer be eligible for payment at a higher rate.

The SCHIP Extension Act requires the Secretary, in consultation with providers, trade organizations and the Medicare Payment Advisory Commission, to prepare an analysis of the compliance threshold for the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. Among other things, the analysis must include the potential effect of the 75% rule on access to care, alternatives to the 75% rule policy for certifying inpatient rehabilitation hospitals, and the appropriate setting of care for conditions of patients commonly admitted to IRFs that are not one of the 13 specified conditions. In requiring the Secretary to produce a recommendation for classifying IRFs, Congress used the term 75% rule for the first time to describe the compliance threshold requirement, while at the same time freezing the threshold at 60%. The results of this analysis may impact future policies, regulations and statutes governing IRF-PPS.

August 2008 Final Rule. On August 8, 2008, CMS published the final rule for IRF PPS for FY 2009. The final rule includes changes to the IRF PPS regulations designed to implement portions of the SCHIP Extension Act. In particular, the patient classification criteria compliance threshold is established at 60 percent (with comorbidities counting toward this threshold). In addition to updating the various values that compose the IRF-PPS, the final rule increased the outlier threshold amount to $10,250 from $7,362 for fiscal year 2007. CMS also updated the CMG relative weights and average length of stay values.

August 2009 Final Rule. On August 7, 2009, CMS published its final rule establishing the annual payment rate update for the IRF-PPS for FY 2010 (affecting discharges and cost reporting periods beginning on October 1, 2009 through September 30, 2010). The standard federal rate is established at $13,661 for FY 2010, an increase from

$12,958 in FY 2009. The proposed outlier threshold amount is set at $10,652, an increase from $10,250 in FY 2009.

In the same final rule, CMS adopted new coverage criteria, including requirements for preadmission screening, post-admission evaluations, and individualized treatment planning that emphasize the role of physicians in ordering and overseeing beneficiaries IRF care. Among other things, the rule requires IRF services to be ordered by a

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rehabilitation physician with specialized training and experience in rehabilitation services and be coordinated by an interdisciplinary team meeting the rule s specifications. The interdisciplinary team must meet weekly to review the patient s progress and make any needed adjustments to the individualized plan of care. IRFs must use qualified personnel to provide required rehabilitation nursing, physical therapy, occupational therapy, speech-language pathology, social services, psychological services, and prosthetic and orthotic services (CMS notes that it also is considering adopting specific standards on the use of group therapies at a future date). The rule also includes new documentation requirements, including a requirement that IRFs submit patient assessment data on Medicare Advantage patients. While the final rule s payment rate updates are effective for IRF discharges on or after October 1, 2009, CMS has adopted a January 1, 2010 effective date for the new coverage requirements to provide facilities more time to comply with the new framework. If we fail to implement the new coverage criteria, claims for our services may be denied in whole or in part.

Specialty Hospital Medicaid Reimbursement. The Medicaid program is designed to provide medical assistance to individuals unable to afford care. The program is governed by the Social Security Act of 1965 and administered and funded jointly by each individual state government and CMS. Medicaid payments are made under a number of different systems, which include cost based reimbursement, prospective payment systems or programs that negotiate payment levels with individual hospitals. In addition, Medicaid programs are subject to statutory and regulatory changes, administrative rulings, interpretations of policy by the state agencies and certain government funding limitations, all of which may increase or decrease the level of program payments to our hospitals. Net operating revenues generated directly from the Medicaid program represented approximately 2.9% of our specialty hospital net operating revenues for both the year ended December 31, 2008 and for the six months ended June 30, 2009.

Workers Compensation. Net operating revenues generated directly from Workers compensation programs represented approximately 20.2% of our net operating revenue from outpatient rehabilitation services for the year ended December 31, 2008 and 19.5% for the six months ended June 30, 2009. Workers compensation is a state mandated, comprehensive insurance program that requires employers to fund or insure medical expenses, lost wages and other costs resulting from work related injuries and illnesses. Workers compensation benefits and arrangements vary on a state-by-state basis and are often highly complex. In some states, payment for services covered by workers compensation programs are subject to cost containment features, such as requirements that all workers compensation injuries be treated through a managed care program, or the imposition of payment caps. In addition, these workers compensation programs may impose requirements that affect the operations of our outpatient rehabilitation services.

Federal Health Care Reform Proposals

Additional changes in federal health care policy have been proposed by President Obama and are expected to be considered by Congress this year. Specifically, on February 26, 2009, the Obama Administration released its proposed federal budget for fiscal year 2010, which would establish a reserve fund of $633.8 billion over 10 years to finance comprehensive health reform. The reserve fund would be paid for by tax increases and health system savings. Among other things, the plan calls for bundled payments to hospitals that would cover not just the hospitalization, but care from certain post-acute providers for the 30 days after the hospitalization. A significant portion of the services furnished by our specialty hospitals and outpatient rehabilitation clinics are to patients discharged from acute care hospitals. Therefore, the proposal to bundle payments to hospitals could have a material impact on volume of referrals to our facilities by acute care hospitals and the payment rates that we receive for our services.

On June 15, 2009, the Obama Administration released new proposals to cut an additional $313 billion from Medicare and Medicaid over 10 years, in addition to the provisions included in the Administration s proposed fiscal year 2010 budget. Among other things, the Administration endorses adopting the Medicare Payment Advisory Commission s recommendations for reducing payments in 2010 to inpatient rehabilitation facilities and long-term care hospitals, including a proposal to reduce payments to long term acute care hospitals by 1.8 percent. In addition, the

Administration endorses implementing additional prepayment reviews in order to cut waste, fraud, and abuse in the federal health care programs.

Other Healthcare Regulations

Medicare Recovery Audit Contractors

The Tax Relief and Health Care Act of 2006 instructed CMS to contract with third-party organizations, known as recovery audit contractors, or RACs, to identify Medicare underpayments and overpayments, and to authorize RACs to recoup any overpayments. The compensation paid to each RAC is based on a percentage of overpayment recoveries identified by the RAC. CMS has selected and entered into contracts with four RACs, which will begin their audit activities by 2010. RAC audits of our Medicare reimbursement may lead to assertions that we have been overpaid, require us to incur additional costs to respond to requests for records and pursue the reversal of payment denials, and ultimately require us to refund any amounts determined to have been overpaid. We cannot predict the impact of future RAC reviews on our results of operations or cash flows.

Fraud and Abuse Enforcement. Various federal and state laws prohibit the submission of false or fraudulent claims, including claims to obtain payment under Medicare, Medicaid and other government healthcare programs. Penalties for violation of these laws include civil and criminal fines, imprisonment and exclusion from participation in federal and state healthcare programs. In recent years, federal and state government agencies have increased the level of enforcement resources and activities targeted at the healthcare industry. In addition, the federal False Claims Act and similar state statutes allow individuals to bring lawsuits on behalf of the government, in what are known as qui tam or whistleblower actions, alleging false or fraudulent Medicare or Medicaid claims or other violations of the statute. The use of these private enforcement actions against healthcare providers has increased dramatically in recent years, in part because the individual filing the initial complaint is entitled to share in a portion of any settlement or judgment. See Legal Proceedings.

From time to time, various federal and state agencies, such as the Office of the Inspector General of the Department of Health and Human Services, issue a variety of pronouncements, including fraud alerts, the Office of Inspector General s Annual Work Plan and other reports, identifying practices that may be subject to heightened scrutiny. These pronouncements can identify issues relating to long term acute care hospitals, inpatient rehabilitation facilities or outpatient rehabilitation services or providers. For example, the Office of Inspector General s 2005 Work Plan describes plans to study whether patients in long term acute care hospitals are receiving acute-level services or could be cared for in skilled nursing facilities. The 2006 and 2007 Work Plans describe plans: (1) to study the accuracy of Medicare payment for inpatient rehabilitation stays when patient assessments are entered later than the required deadlines, (2) to study both inpatient rehabilitation facility and long term acute care hospital payments in order to determine whether they were made in accordance with applicable regulations, including policies on outlier payments and interrupted stays, and (3) to study physical and occupational therapy claims in order to determine whether the services were medically necessary, adequately documented and certified. The 2007 Work Plan describes plans to study the extent to which long term acute care hospitals admit patients from a sole general acute care hospital and whether hospitals currently reimbursed under LTCH-PPS are in compliance with the average length of stay criteria. We monitor government publications applicable to us and focus a portion of our compliance efforts towards these areas targeted for enforcement.

We endeavor to conduct our operations in compliance with applicable laws, including healthcare fraud and abuse laws. If we identify any practices as being potentially contrary to applicable law, we will take appropriate action to address the matter, including, where appropriate, disclosure to the proper authorities, which may result in a voluntary refund of monies to Medicare, Medicaid or other governmental health care programs.

Remuneration and Fraud Measures. The federal anti-kickback statute prohibits some business practices and relationships under Medicare, Medicaid and other federal healthcare programs. These practices include the payment,

receipt, offer or solicitation of remuneration in connection with, to induce, or to arrange for, the referral of patients covered by a federal or state healthcare program. Violations of the anti-kickback law may be punished by a criminal fine of up to $50,000 or imprisonment for each violation, or both, civil monetary penalties of $50,000 and damages of up to three times the total amount of remuneration, and exclusion from participation in federal or state healthcare programs.

Section 1877 of the Social Security Act, commonly known as the Stark Law, prohibits referrals for designated health services by physicians under the Medicare and Medicaid programs to other healthcare providers in which the physicians have an ownership or compensation arrangement unless an exception applies. Sanctions for

violating the Stark Law include civil monetary penalties of up to $15,000 per prohibited service provided, assessments equal to three times the dollar value of each such service provided and exclusion from the Medicare and Medicaid programs and other federal and state healthcare programs. The statute also provides a penalty of up to $100,000 for a circumvention scheme. In addition, many states have adopted or may adopt similar anti-kickback or anti-self-referral statutes. Some of these statutes prohibit the payment or receipt of remuneration for the referral of patients, regardless of the source of the payment for the care. While we do not believe our arrangements are in violation of these prohibitions, we cannot assure you that governmental officials charged with the responsibility for enforcing the provisions of these prohibitions will not assert that one or more of our arrangements are in violation of the provisions of such laws and regulations.

Provider-Based Status. The designation provider-based refers to circumstances in which a subordinate facility (e.g., a separately certified Medicare provider, a department of a provider or a satellite facility) is treated as part of a provider for Medicare payment purposes. In these cases, the services of the subordinate facility are included on the main provider s cost report and overhead costs of the main provider can be allocated to the subordinate facility, to the extent that they are shared. We operate 13 specialty hospitals that are treated as provider-based satellites of certain of our other facilities, certain of our outpatient rehabilitation services are operated as departments of our inpatient rehabilitation facilities, and we provide rehabilitation management and staffing services to hospital rehabilitation departments that may be treated as provider-based. These facilities are required to satisfy certain operational standards in order to retain their provider-based status.

Health Information Practices. In addition to broadening the scope of the fraud and abuse laws, the Health Insurance Portability and Accountability Act of 1996 also mandates, among other things, the adoption of standards for the exchange of electronic health information in an effort to encourage overall administrative simplification and enhance the effectiveness and efficiency of the healthcare industry. If we fail to comply with the standards, we could be subject to criminal penalties and civil sanctions. Among the standards that the Department of Health and Human Services has adopted or will adopt pursuant to the Health Insurance Portability and Accountability Act of 1996 are standards for electronic transactions and code sets, unique identifiers for providers (referred to as National Provider Identifier), employers, health plans and individuals, security and electronic signatures, privacy and enforcement.

The Department of Health and Human Services has adopted standards in three areas that most affect our operations.

Standards relating to the privacy of individually identifiable health information govern our use and disclosure of protected health information and require us to impose those rules, by contract, on any business associate to whom such information is disclosed. We were required to comply with these standards by April 14, 2003.

Standards relating to electronic transactions and code sets require the use of uniform standards for common healthcare transactions, including healthcare claims information, plan eligibility, referral certification and authorization, claims status, plan enrollment and disenrollment, payment and remittance advice, plan premium payments and coordination of benefits. We were required to comply with these requirements by October 16, 2003.

Standards for the security of electronic health information require us to implement various administrative, physical and technical safeguards to ensure the integrity and confidentiality of electronic protected health information. We were required to comply with these security standards by April 20, 2005.

The National Provider Identifier will replace health care provider identifiers that are in use today in standard transactions. Implementation of the National Provider Identifier will eliminate the need for health care providers to use different identification numbers to identify themselves when conducting standard transactions with multiple health plans. We were required to comply with the use of National Provider Identifiers in standard transactions by May 23, 2007.

We maintain a HIPAA committee that is charged with evaluating and monitoring our compliance with the Health Insurance Portability and Accountability Act of 1996. The HIPAA committee monitors regulations promulgated under the Health Insurance Portability and Accountability Act of 1996 as they have been adopted to date and as additional standards and modifications are adopted. Although health information standards have had a significant effect on the manner in which we handle health data and communicate with payors, the cost of our compliance has not had a material adverse effect on our business, financial condition or results of operations. We

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cannot estimate the cost of compliance with standards that have not been issued or finalized by the Department of Health and Human Services.

Compliance Program

Our Compliance Program

In late 1998, we voluntarily adopted our code of conduct. The code is reviewed and amended as necessary and is the basis for our company-wide compliance program. Our written code of conduct provides guidelines for principles and regulatory rules that are applicable to our patient care and business activities. These guidelines are implemented by a compliance officer, a compliance committee, and employee education and training. We also have established a reporting system, auditing and monitoring programs, and a disciplinary system as a means for enforcing the code s policies.

Operating Our Compliance Program

We focus on integrating compliance responsibilities with operational functions. We recognize that our compliance with applicable laws and regulations depends upon individual employee actions as well as company operations. As a result, we have adopted an operations team approach to compliance. Our corporate executives, with the assistance of corporate experts, designed the programs of the compliance committee. We utilize facility leaders for employee-level implementation of our code of conduct. This approach is intended to reinforce our company-wide commitment to operate in accordance with the laws and regulations that govern our business.

Compliance Committee

Our compliance committee is made up of members of our senior management and in-house counsel. The compliance committee meets on a quarterly basis and reviews the activities, reports and operation of our compliance program. In addition, the HIPAA committee meets on a regular basis to review compliance with regulations promulgated under the Health Insurance Portability and Accountability Act of 1996 and provides reports to the compliance committee.

Compliance Issue Reporting

In order to facilitate our employees ability to report known, suspected or potential violations of our code of conduct, we have developed a system of anonymous reporting. This anonymous reporting may be accomplished through our toll free compliance hotline, compliance e-mail address or our compliance post office box. The compliance officer and the compliance committee are responsible for reviewing and investigating each compliance incident in accordance with the compliance department s investigation policy.

Compliance Monitoring and Auditing / Comprehensive Training and Education

Monitoring reports and the results of compliance for each of our business segments are reported to the compliance committee on a quarterly basis. We train and educate our employees regarding the code of conduct, as well as the legal and regulatory requirements relevant to each employee s work environment. New and current employees are required to sign a compliance certification form certifying that the employee has read, understood and has agreed to abide by the code of conduct. Additionally, all employees are required to re-certify compliance with the code on an annual basis.

Policies and Procedures Reflecting Compliance Focus Areas

We review our policies and procedures for our compliance program from time to time in order to improve operations and to ensure compliance with requirements of standards, laws and regulations and to reflect the ongoing compliance focus areas which have been identified by the compliance committee.

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Internal Audit

In addition to and in support of the efforts of our compliance department, during 2001 we established an internal audit function. The compliance officer manages the combined Compliance and Audit Department and meets with the audit committee of the board of directors on a quarterly basis to discuss audit results.

Corporate Information

We are a corporation organized under the laws of the State of Delaware. Our principal executive offices are located at 4714 Gettysburg Road, Mechanicsburg, Pennsylvania 17055. Our telephone number at our principal executive offices is (717) 972-1100. Our company s website can be located at www.selectmedicalcorp.com. The information on our company s website is not part of this prospectus.

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MANAGEMENT

Executive Officers and Directors

The following table sets forth certain information with respect to our executive officers and directors as of August 31, 2009.

Name	Age	Position
Rocco A. Ortenzio	76	Director and Executive Chairman
Robert A. Ortenzio	52	Director and Chief Executive Officer
Russell L. Carson	66	Director
David S. Chernow	52	Director
Bryan C. Cressey	59	Director
James E. Dalton, Jr.	66	Director
James S. Ely III	51	Director
Thomas A. Scully	51	Director
Leopold Swergold	69	Director
Sean M. Traynor	40	Director
Patricia A. Rice	62	President and Chief Operating Officer
David W. Cross	62	Executive Vice President and Chief Development Officer
S. Frank Fritsch	58	Executive Vice President and Chief Human Resources Officer
Martin F. Jackson	55	Executive Vice President and Chief Financial Officer
James J. Talalai	48	Executive Vice President and Chief Information Officer
Michael E. Tarvin	49	Executive Vice President, General Counsel and Secretary
Scott A. Romberger	49	Senior Vice President, Controller and Chief Accounting Officer
Robert G. Breighner, Jr.	40	Vice President, Compliance and Audit Services and Corporate Compliance Officer

Set forth below is a brief description of the business experience of each of our directors and executive officers:

Rocco A. Ortenzio co-founded our company and he served as Chairman and Chief Executive Officer from February 1997 until September 2001. Mr. Ortenzio has served as Executive Chairman since September 2001. He became a director of Holdings upon the consummation of the Merger Transactions. In 1986, he co-founded Continental Medical Systems, Inc., and served as its Chairman and Chief Executive Officer until July 1995. In 1979, Mr. Ortenzio founded Rehab Hospital Services Corporation, and served as its Chairman and Chief Executive Officer until June 1986. In 1969, Mr. Ortenzio founded Rehab Corporation and served as its Chairman and Chief Executive Officer until 1974. Mr. Ortenzio is the father of Robert A. Ortenzio, our Chief Executive Officer.

Robert A. Ortenzio co-founded our company and has served as a director of Select since February 1997. He became a director of Holdings upon the consummation of the Merger Transactions. Mr. Ortenzio has served as our Chief Executive Officer since January 1, 2005 and as our President and Chief Executive Officer from September 2001 to January 1, 2005. Mr. Ortenzio also served as our President and Chief Operating Officer from February 1997 to September 2001. He was an Executive Vice President and a director of Horizon/CMS Healthcare Corporation from

July 1995 until July 1996. In 1986, Mr. Ortenzio co-founded Continental Medical Systems, Inc., and served in a number of different capacities, including as a Senior Vice President from February 1986 until April 1988, as Chief

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Operating Officer from April 1988 until July 1995, as President from May 1989 until August 1996 and as Chief Executive Officer from July 1995 until August 1996. Before co-founding Continental Medical Systems, Inc., he was a Vice President of Rehab Hospital Services Corporation. He currently serves on the board of directors of Odyssey Healthcare, Inc., a hospice health care company, and U.S. Oncology, Inc. Mr. Ortenzio is the son of Rocco A. Ortenzio, our Executive Chairman.

Russell L. Carson has served as a director of Select since February 1997, and became a director of Holdings upon the consummation of the Merger Transactions. He co-founded Welsh, Carson, Anderson & Stowe in 1978 and has focused on healthcare investments. Mr. Carson has been a general partner of Welsh, Carson, Anderson & Stowe since 1979. Welsh, Carson, Anderson & Stowe has created 15 institutionally funded limited partnerships with total capital of more than $18 billion and has invested in more than 200 companies. Before co-founding Welsh, Carson, Anderson & Stowe, Mr. Carson was employed by Citicorp Venture Capital Ltd., a subsidiary of Citigroup, Inc., and served as its Chairman and Chief Executive Officer from 1974 to 1978. He currently serves on the board of directors of U.S. Oncology, Inc.

David S. Chernow served as a director of Select from January 2002 until the consummation of the Merger Transactions on February 24, 2005, and became a director of Holdings in August 2005. Mr. Chernow is the President and Chief Executive Officer of Oncure Medical Corp., one of the largest providers of free-standing radiation oncology care in the United States. From January 2004 to June 2007, Mr. Chernow served as the President and Chief Executive Officer of JA Worldwide, a nonprofit organization dedicated to the education of young people about business. From July 2001 to January 2004, he served as the President and Chief Executive Officer of Junior Achievement, Inc., a predecessor of JA Worldwide. From 1999 to 2001, he was the President of the Physician Services Group at US Oncology, Inc. Mr. Chernow co-founded American Oncology Resources in 1992 and served as its Chief Development Officer until the time of the merger with Physician Reliance Network, Inc., which created US Oncology, Inc. in 1999.

Bryan C. Cressey has served as a director of Select since February 1997, and became a director of Holdings upon the consummation of the Merger Transactions. He is a partner of Cressey & Company, which he founded in 2007. He is a managing partner of Thoma Cressey Bravo, which he co-founded in June 1998. Prior to that time he was a principal, partner and co-founder of Golder, Thoma, Cressey and Rauner, the predecessor of GTCR Golder Rauner, LLC, since 1980. Mr. Cressey also serves as a director and chairman of Belden Inc., Jazz Pharmaceuticals, Inc. and several private companies.

James E. Dalton, Jr. served as a director of Select from December 2000 until the consummation of the Merger Transactions on February 24, 2005, and became a director of Holdings in August 2005. Since January 1, 2006, Mr. Dalton has been Chairman of Signature Hospital Corporation. From 2001 to 2007, Mr. Dalton served as President of Edinburgh Associates, Inc. Mr. Dalton served as President, Chief Executive Officer and as a director of Quorum Health Group, Inc. from May 1, 1990 until it was acquired by Triad Hospitals, Inc. in April 2001. Mr. Dalton also serves on the board of directors of U.S. Oncology, Inc. He serves as a Trustee for the Universal Health Services Realty Income Trust. Mr. Dalton is a Life Fellow of the American College of Healthcare Executives.

James S. Ely III has served as a director of Select and Holdings since November 2008. Mr. Ely founded Priority Capital Management LLC in 2009 and serves as its Chief Executive Officer. From 2001 to 2008, Mr. Ely served as a Managing Director in the Syndicated and Leveraged Finance group at J.P. Morgan Securities Inc. From 1995 to 2000, Mr. Ely served as a Managing Director in the Global Syndicated Finance group of Chase Securities Inc. and its predecessor Chemical Securities Inc. Mr. Ely also serves as a director of Community Health Systems, Inc.

Thomas A. Scully has served as a director of Select since February 2004, and became a director of Holdings upon the consummation of the Merger Transactions. Since January 1, 2004, he has served as Senior Counsel to the law firm of Alston & Bird and as a General Partner with Welsh, Carson Anderson & Stowe. From May 2001 to January 2004,

Mr. Scully served as Administrator of the Centers for Medicare & Medicaid Services, or CMS. CMS is responsible for the management of Medicare, Medicaid, SCHIP and other national healthcare initiatives. Before joining CMS, Mr. Scully served as President and Chief Executive Officer of the Federation of American Hospitals from January 1995 to May 2001. Mr. Scully also serves as a director of Universal American Financial Corp.

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Leopold Swergold served as a director of Select from May 2001 until the consummation of the Merger Transactions, and became a director of Holdings in August 2005. In 1983, Mr. Swergold formed Swergold, Chefitz & Company, a healthcare investment banking firm. In 1989, Swergold, Chefitz & Company merged into Furman Selz, an investment banking firm, where Mr. Swergold served as Head of Healthcare Investment Banking and as a member of the board of directors. In 1997, Furman Selz was acquired by ING Groep N.V. of the Netherlands. From 1997 until 2004, Mr. Swergold was a Managing Director of ING Furman Selz Asset Management LLC, where he managed several healthcare investment funds. Mr. Swergold serves as a director of Financial Federal Corp., a New York Stock Exchange listed company, and is a trustee of the Freer and Sackler Galleries at the Smithsonian Institution.

Sean M. Traynor has served as a director of Holdings since October 2004, and became a director of Select upon the consummation of the Merger Transactions. Mr. Traynor is a general partner of Welsh, Carson, Anderson & Stowe, where he focuses on investments in healthcare. Prior to joining Welsh Carson in April 1999, Mr. Traynor worked in the healthcare and financial services investment banking groups at BT Alex Brown after spending three years with Coopers & Lybrand. Mr. Traynor serves as a director of Renal Advantage Inc., AGA Medical Corporation, Amerisafe, Inc. and Universal American Corporation.

Patricia A. Rice has served as our President and Chief Operating Officer since January 1, 2005. Prior to this, she served as our Executive Vice President and Chief Operating Officer since January 2002 and as our Executive Vice President of Operations from November 1999 to January 2002. She served as Senior Vice President of Hospital Operations from December 1997 to November 1999. She was Executive Vice President of the Hospital Operations Division for Continental Medical Systems, Inc. from August 1996 until December 1997. Prior to that time, she served in various management positions at Continental Medical Systems, Inc. from 1987 to 1996.

David W. Cross has served as our Executive Vice President and Chief Development Officer since February 2007. He served as our Senior Vice President and Chief Development Officer from December 1998 to February 2007. Before joining us, he was President and Chief Executive Officer of Intensiva Healthcare Corporation from 1994 until we acquired it. Mr. Cross was a founder, the President and Chief Executive Officer, and a director of Advanced Rehabilitation Resources, Inc., and served in each of these capacities from 1990 to 1993. From 1987 to 1990, he was Senior Vice President of Business Development for RehabCare Group, Inc., a publicly traded rehabilitation care company, and in 1993 and 1994 served as Executive Vice President and Chief Development Officer of RehabCare Group, Inc. Mr. Cross currently serves on the board of directors of Odyssey Healthcare, Inc., a hospice health care company.

S. Frank Fritsch has served as our Executive Vice President and Chief Human Resources Officer since February 2007. He served as our Senior Vice President of Human Resources from November 1999 to February 2007. He served as our Vice President of Human Resources from June 1997 to November 1999. Prior to June 1997, he was Senior Vice President Human Resources for Integrated Health Services from May 1996 until June 1997. Prior to that time, Mr. Fritsch was Senior Vice President Human Resources for Continental Medical Systems, Inc. from August 1992 to April 1996. From 1980 to 1992, Mr. Fritsch held senior human resources positions with Mercy Health Systems, Rorer Pharmaceuticals, ARA Mark and American Hospital Supply Corporation.

Martin F. Jackson has served as our Executive Vice President and Chief Financial Officer since February 2007. He served as our Senior Vice President and Chief Financial Officer from May 1999 to February 2007. Mr. Jackson previously served as a Managing Director in the Health Care Investment Banking Group for CIBC Oppenheimer from January 1997 to May 1999. Prior to that time, he served as Senior Vice President, Health Care Finance with McDonald & Company Securities, Inc. from January 1994 to January 1997. Prior to 1994, Mr. Jackson held senior financial positions with Van Kampen Merritt, Touche Ross, Honeywell and L Nard Associates. Mr. Jackson also serves as a director of several private companies.

James J. Talalai has served as our Executive Vice President and Chief Information Officer since February 2007. He served as our Senior Vice President and Chief Information Officer from August 2001 to February 2007. He joined our company in May 1997 and served in various leadership capacities within Information Services. Before joining us, Mr. Talalai was Director of Information Technology for Horizon/ CMS Healthcare Corporation from 1995 to 1997. He also served as Data Center Manager at Continental Medical Systems, Inc. in the

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mid-1990s. During his career, Mr. Talalai has held development positions with PHICO Insurance Company and with Harrisburg HealthCare.

Michael E. Tarvin has served as our Executive Vice President, General Counsel and Secretary since February 2007. He served as our Senior Vice President, General Counsel and Secretary from November 1999 to February 2007. He served as our Vice President, General Counsel and Secretary from February 1997 to November 1999. He was Vice President Senior Counsel of Continental Medical Systems from February 1993 until February 1997. Prior to that time, he was Associate Counsel of Continental Medical Systems from March 1992. Mr. Tarvin was an associate at the Philadelphia law firm of Drinker Biddle & Reath, LLP from September 1985 until March 1992.

Scott A. Romberger has served as our Senior Vice President and Controller since February 2007. He served as our Vice President and Controller from February 1997 to February 2007. In addition, he has served as our Chief Accounting Officer since December 2000. Prior to February 1997, he was Vice President Controller of Continental Medical Systems from January 1991 until January 1997. Prior to that time, he served as Acting Corporate Controller and Assistant Controller of Continental Medical Systems from June 1990 and December 1988, respectively. Mr. Romberger is a certified public accountant and was employed by a national accounting firm from April 1985 until December 1988.

Robert G. Breighner, Jr. has served as our Vice President, Compliance and Audit Services since August 2003. He served as our Director of Internal Audit from November 2001 to August 2003. Previously, Mr. Breighner was Director of Internal Audit for Susquehanna Pfaltzgraff Co. from June 1997 until November 2001. Mr. Breighner held other positions with Susquehanna Pfaltzgraff Co. from May 1991 until June 1997.

Director Independence

Our board of directors currently consists of ten directors, Messrs. Rocco Ortenzio, Robert Ortenzio, Carson, Chernow, Cressey, Dalton, Ely, Scully, Swergold and Traynor. No later than twelve months after we list our common stock on the New York Stock Exchange, a majority of our directors will be required to meet standards of independence. In 2009, our board of directors undertook a review of the independence of our directors and considered whether any director has a material relationship with us that could compromise his ability to exercise independent judgment in carrying out his responsibilities. We believe that Messrs. Chernow, Cressey, Dalton, Ely, and Swergold currently meet these independence standards.

Board Committees

Our board of directors will establish various committees to assist it with its responsibilities. Those committees are described below.

Audit Committee

The current audit committee members are Messrs. Cressey, Dalton, Ely, Swergold and Traynor. Upon the date our common stock is listed on the New York Stock Exchange, our board of directors will reconstitute our audit committee to consist of at least three directors. The initial committee members will be Messrs. Chernow, Dalton, Ely, and Swergold. The composition of the audit committee will satisfy the independence and financial literacy requirements of the New York Stock Exchange and the Securities and Exchange Commission. The financial literacy standards require that each member of our audit committee be able to read and understand fundamental financial statements. In addition, at least one member of our audit committee must qualify as a financial expert, as defined by the rules and regulations of the Securities and Exchange Commission, and have financial sophistication in accordance with the rules of the New York Stock Exchange. Our board of directors has determined that each of our audit committee members qualify

as an audit committee financial expert.

The primary responsibility of the audit committee it to oversee our financial reporting process on behalf of our board of directors and regularly report the results of its activities to our board of directors. The audit committee assists our board of directors in the oversight of the integrity of our financial statements and the financial reporting process, the systems of internal accounting and financial controls, the performance of our internal audit function and independent auditors, the independent auditor s qualifications and independence, the annual independent audit

of our financial statements, our corporate governance structure and guidelines, legal compliance and ethics programs established by our management and board of directors and our compliance with ethics and legal policies and regulatory requirements.

To fulfill these duties and responsibilities, the audit committee will:

Independent and Internal Auditor

have direct responsibility for the appointment (subject, if applicable, to stockholder ratification), termination, compensation and oversight of the work of the independent auditors, including resolution of disagreements between management and the auditors regarding financial reporting;

have the authority to approve all fees and terms of engagement of the independent auditors and will pre-approve all audit and non-audit services provided by the independent auditors and will not engage the independent auditors to perform any non-audit services proscribed by law or regulation;

have a clear understanding with management and the independent auditors that the independent auditors are ultimately accountable to our board of directors and the audit committee, as representatives of our stockholders;

have the ultimate authority and responsibility to evaluate and, where appropriate, replace the independent auditors;

discuss with the auditors their independence from management and us and the matters included in the written disclosures required by the Public Company Accounting Oversight Board;

review on an annual basis the performance of our independent auditors and determine whether to reappoint the auditors for the upcoming fiscal year, subject to stockholder approval, if applicable;

set clear hiring policies for employees or former employees of the independent auditors that comply with the rules and regulations of the Securities and Exchange Commission and applicable listing standards of the New York Stock Exchange;

receive regular reports from the independent auditors on our critical policies and practices, and all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management;

discuss with the internal auditors and the independent auditors the overall scope and plans for their respective audits, including the adequacy of staffing and compensation;

Internal Controls

obtain and review a report by the independent auditors at least annually describing: (1) the independent auditors internal quality control procedures, (2) any material issues raised by the most recent internal quality control review, or peer review, of the independent auditors, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the independent auditors, and any steps taken to deal with any such issues; (3) all relationships between the independent auditor and us that may impact the objectivity and independence of the auditor (to assess the auditor s independence), and (4) discuss with management, the internal auditors and the independent auditors

the adequacy and effectiveness of the accounting and financial controls, including our policies and procedures to assess, monitor, and manage business risk and legal and ethical compliance programs;

review management s assertion on its assessment of the effectiveness of internal controls as of the end of the most recent fiscal year and the independent auditors report on management s assertion;

establish procedures for the receipt, retention and treatment of complaints received by us regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by our employees of concerns regarding questionable accounting or auditing matters;

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Financial Reporting

review the interim financial statements and disclosures made under the section entitled *Management s Discussion and Analysis of Financial Condition and Results of Operations* with management and the independent auditors prior to the filing of our Quarterly Report on Form 10-Q, and discuss the results of the quarterly review and any other matters required to be communicated to the audit committee by the independent auditors under generally accepted auditing standards;

review with management and the independent auditors the annual financial statements and disclosures made under the section entitled *Management s Discussion and Analysis of Financial Condition and Results of Operations* to be included in our Annual Report on Form 10-K (or the annual report to stockholders if distributed prior to the filing of Form 10-K), including their judgment about the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments and the clarity of the disclosures in the financial statements, and discuss the results of the annual audit and any other matters required to be communicated to the audit committee by the independent auditors under generally accepted auditing standards;

review and discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies prior to their release;

prepare its report to be included in our annual proxy statement as required by the rules and regulations of the Securities and Exchange Commission;

Miscellaneous

periodically meet separately with management, the internal auditors and the independent auditors to discuss issues and concerns warranting the attention of the audit committee, and provide sufficient opportunity to meet privately with the internal auditors and the independent auditors;

review with the independent auditors any audit problems or difficulties and management s response;

receive corporate attorneys reports of evidence of a material violation of securities laws or breaches of fiduciary duty; and

perform an evaluation of its performance at least annually to determine whether it is functioning effectively.

The audit committee may supplement the above activities as appropriate in order to best react to changing conditions and circumstances and will take appropriate actions to set the overall corporate tone for quality financial reporting, sound business risk practices and ethical behavior. In discharging its oversight role, the audit committee will be empowered to investigate any matter brought to its attention with full access to our books, records, facilities and personnel and retain independent outside counsel or other experts or advisers as necessary.

The audit committee will hold regular meetings at least four times each year. The audit committee will report to the board of directors at each regularly scheduled meeting of our board of directors on significant results of its activities.

Prior to the consummation of this offering, our board of directors will amend and restate the charter for our audit committee. PricewatehouseCoopers LLP currently serves as our independent auditor.

Nominating and Corporate Governance Committee

Upon the date our common stock is listed on the New York Stock Exchange, our board of directors will designate a nominating and corporate governance committee that will consist of at least two directors. The initial committee members will be Messrs. Dalton and Swergold. The composition of the nominating and corporate governance committee will satisfy the independence requirements of the New York Stock Exchange that it have all independent directors. The nominating and corporate governance committee will be appointed to:

- identify individuals qualified to serve on our board of directors and our board committees;

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recommend to our board of directors nominees for election to our board of directors at annual meetings of stockholders;

recommend to our board the directors nominees to serve on each of our board committees;

lead our board of directors in its annual review of the performance of our board of directors and management;

monitor our corporate governance structure;

develop and recommend to our board of directors a set of corporate governance guidelines and a code of business conduct and ethics; and

assist our board of directors in monitoring our compliance with applicable legal and regulatory requirements.

To fulfill these responsibilities, the nominating and corporate governance committee will:

Composition, Performance and Compensation of our Board of Directors

develop qualifications and other criteria for individual candidates for our board of directors including, without limitation, background, technical and industry-specific skills, affiliations and personal characteristics;

identify candidates for election or re-election to our board of directors, including candidates recommended by our stockholders, gather information on candidates, conduct interviews and hold meetings with candidates, make recommendations to our board of directors as to particular candidates to fill vacancies on our board of directors from time to time and make recommendations to our board of directors as to the slate of candidates for election or re-election to our board of directors to be presented to the stockholders for consideration at our annual meeting of stockholders;

review the composition and size of our board of directors as a whole, in order to ensure that our board of directors has the appropriate experience, expertise and perspective;

on a regular basis, but not less frequently than annually, conduct an assessment and evaluation of the performance of our board of directors, as a whole, and the directors individually, and make recommendations to our board of directors as to whether individual directors should stand for re-election;

Succession Planning

in consultation with our chief executive officer, review succession planning relating to our chief executive officer as well as other key members of our senior management, and require our chief executive officer to prepare and update regularly his or her recommendation as to the individual who should succeed him or her in the event he or she becomes unable to perform the duties of the office;

plan for continuity on our board of directors as existing directors retire or rotate off our board of directors;

Board Committees

review on an annual basis the compliance by each board committee with our committee structure, size and composition rules, including holding the required number of meetings and providing to our board of directors

reports as to that committee s activities;

recommend to our board of directors individual directors to serve as members and chairpersons of the various board committees and recommend changes to the composition of committees from time to time, and ensure that each committee is comprised of members with experience and expertise sufficient for the committee to perform its responsibilities and maintain a diversity of perspective and background;

review on an annual basis its own performance and report the results of such review to our board of directors;

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Governance

review on an annual basis the compliance of our board of directors with Securities and Exchange Commission and New York Stock Exchange rules, including (if appropriate) preparation and review of any required committee report for our annual report or proxy statement;

develop and recommend to our board of directors for its approval a set of corporate governance guidelines;

review periodically the adequacy of the corporate governance guidelines and recommend any proposed changes to the corporate governance guidelines to our board of directors for its approval;

review on an annual basis our compliance with the corporate governance guidelines;

consult with the chairperson and the chief executive officer with respect to carrying out the responsibilities of the committee and implementing those recommendations of the committee adopted by our board of directors;

Conflicts of Interest

in connection with our filing of our Annual Report on Form 10-K, review the independence and other qualifications of our directors, consider questions of possible conflicts of interest between our directors or management and us and our subsidiaries, and monitor all other activities of our directors or management that could interfere with such individuals duties;

identify, analyze and, if possible, resolve actual and potential conflicts of interest a director has or may have;

in connection with actual or potential conflicts of interest of a director, issue to such director instructions concerning the manner in which he or she is to conduct himself or herself, as applicable, in matters that are, or may come, before our board of directors including, without limitation, recusal of the director when matters implicated by such conflict of interest come before our board of directors;

Stockholder Matters

periodically review our certificate of incorporation and bylaws, as amended from time to time, and make recommendations to our board of directors with the objective of promoting good corporate governance;

review the procedures and communication plans for stockholders meetings to ensure that the rights of stockholders (including the right to participate) are protected, that required information concerning us is adequately presented and that the meetings promote effective communication between us and our stockholders on matters of importance;

monitor the manner and frequency with which our board of directors and management communicate with stockholders between scheduled stockholders meetings;

annually review and reassess the adequacy of our code of business conduct and ethics, and recommend any proposed changes to our code of business conduct and ethics to our board of directors for its approval; and

consider any requests for waivers from or exceptions to our code of business conduct and ethics for our directors or executive officers, and ensure that we make disclosure of such waivers or exceptions as required by applicable law, regulations and listing requirements.

In addition to the activities described above, the nominating and corporate governance committee will have the authority to confer with our management and other employees to the extent necessary or appropriate to fulfill its responsibilities, and have the authority to conduct or initiate inquiries or investigations into any matters within its scope of responsibilities and have full access to our books, records, facilities and personnel. The nominating and corporate governance committee will also have the authority to retain outside legal or other expert advice, including a search firm to be used to identify director candidates, to the extent necessary or appropriate, and will keep our board of directors reasonably informed as to the nature and extent of such outside advice. The nominating and corporate governance committee will hold regular meetings at least once each year. The nominating and corporate

governance committee will report to our board of directors at each regularly scheduled meeting of our board of directors on significant results of its activities.

Compensation Committee

The current compensation committee members are Russell L. Carson, David S. Chernow, Bryan C. Cressey, Rocco A. Ortenzio and Robert A. Ortenzio. Upon the date our common stock is listed on the New York Stock Exchange, our board of directors will reconstitute our compensation committee to consist of at least two directors. The initial committee members will be Messrs. Carson, Chernow and Cressey. The composition of the compensation committee will satisfy the independence requirements of the New York Stock Exchange that it have at least one independent director on the listing date, a majority of independent directors within 90 days after that date and full compliance within one year after that date. The overall responsibility of the compensation committee is evaluating and approving our executive officer and director compensation plans, policies and programs, as well as all equity-based compensation plans and policies. The compensation committee is also responsible for preparing the Compensation Discussion and Analysis report for inclusion in our annual proxy statement filed with the Securities and Exchange Commission. In that regard, the compensation committee will:

have the sole authority to retain and terminate any compensation consultant used to assist us, our board of directors or the compensation committee in the evaluation of the compensation of our executive officers and directors, and have the sole authority to approve such consultant s fees and other retention terms;

to the extent necessary or appropriate to carry out its responsibilities, have the authority to retain independent legal, accounting, actuarial or other advisors;

have the authority to confer with our management and other employees to the extent necessary or appropriate to fulfill its responsibilities, and have the authority to conduct or initiate inquiries or investigations into any matters within its scope of responsibilities and have full access to our books, records, facilities and personnel;

review and approve on an annual basis the corporate goals and objectives relevant to the compensation of our executive chairman and chief executive officer, evaluate the performance of our executive chairman and chief executive officer in light of those goals and objectives, determine and approve the compensation level of our executive chairman and chief executive officer based on this evaluation, and, in determining the long-term incentive component of the compensation of our executive chairman and chief executive officer, consider our performance and relative stockholder returns, the value of similar incentive awards to the executive chairman and chief executive officer at comparable companies, the awards given to our executive chairman and chief executive officer in past years and other factors as appropriate;

interpret, implement, administer, review and approve all aspects of remuneration to our executive officers and other key officers, including their participation in incentive-compensation plans and equity-based compensation plans;

review and approve all employment agreements, consulting agreements, severance arrangements and change in control agreements or provisions for our executive officers;

develop, approve, administer and recommend to our board of directors and stockholders for their approval (to the extent such approval is required by any applicable law, regulation or rule of the New York Stock Exchange) all of our stock ownership, stock option and other equity-based compensation plans and all related policies and programs;

make individual determinations and grant any shares, stock options, or other equity-based awards under all equity-based compensation plans, and exercise such other power and authority as may be required or permitted under such plans, other than with respect to non-employee directors, which determinations are subject to the approval of our board of directors;

review and discuss with our management the Compensation Discussion and Analysis report to be included in our annual proxy statement as required by the rules and regulations of the Securities and Exchange Commission;

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have the authority to form and delegate authority to subcommittees as appropriate;

report regularly to our board of directors, but not less frequently than annually, and report to our board of directors as frequently as appropriate on the compensation of directors and make recommendations regarding changes to our compensation practices;

review and reassess on an annual basis the adequacy of its charter and recommend any proposed changes to our board of directors for its approval; and

review on an annual basis its own performance, and report the results of such review to our board of directors.

In addition to the activities described above, the compensation committee will perform other functions as necessary or appropriate under all applicable laws, our restated certificate of incorporation, our amended and restated by-laws, and under the resolutions and other directives of our board of directors. The Compensation Committee has the same authority with regard to all aspects of director compensation as it has been granted with regard to executive compensation, except that the ultimate decision regarding the compensation of any director is subject to the approval of our board of directors. The compensation committee will hold regular meetings at least two times each year. The compensation committee will report to our board of directors at each regularly scheduled meeting of our board of directors on significant results of its activities.

Effective upon the consummation of this offering, our board of directors will amend and restate the charter for our compensation committee.

Director Compensation

We do not pay directors fees to our employee directors; however they are reimbursed for the expenses they incur in attending meetings of our board of directors or board committees. Non-employee directors other than non-employee directors appointed by Welsh Carson and Thoma Cressey receive cash compensation in the amount of $6,000 per quarter, and the following for all meetings attended other than audit committee meetings: $1,500 per board meeting, $300 per telephonic board meeting, $500 per committee meeting held in conjunction with a board meeting and $1,000 per committee meeting held independent of a board meeting. For audit committee meetings attended, all members receive the following: $2,000 per audit committee meeting and $1,000 per telephonic audit committee meeting. All non-employee directors are also reimbursed for the expenses they incur in attending meetings of our board of directors or board committees.

Code of Ethics

We have adopted a written code of business conduct and ethics, known as our code of conduct, which applies to all of our directors, officers, and employees, including our chief executive officer, our chief financial officer and our chief accounting officer. Our code of conduct is available on our Internet website, www.selectmedicalcorp.com. Our code of conduct may also be obtained by contacting investor relations at (717) 972-1100. Any amendments to our code of conduct or waivers from the provisions of the code for our chief executive officer, our chief financial officer and our chief accounting officer will be disclosed on our Internet website promptly following the date of such amendment or waiver. The inclusion of our web address in this prospectus does not include or incorporate by reference the information on our web site into this prospectus.

COMPENSATION DISCUSSION AND ANALYSIS

Introduction. This Compensation Discussion and Analysis (CD&A) provides an overview of our executive compensation program together with a description of the material factors underlying the decisions which resulted in the compensation provided for 2008 to our Executive Chairman, Chief Executive Officer, Chief Financial Officer and the two other executive officers who were the highest paid during 2008 (collectively, the named executive officers), as presented in the tables which follow this CD&A. This CD&A contains statements regarding our performance targets and goals. These targets and goals are disclosed in the limited context of our compensation program and should not be understood to be statements of management s expectations or estimates of financial results or other guidance. We specifically caution investors not to apply these statements to other contexts.

Compensation Philosophy. Our compensation philosophy for named executive officers is designed with the primary goals of rewarding the contributions of named executive officers to our financial performance and providing overall compensation sufficient to attract and retain highly skilled named executive officers who are properly motivated to contribute to our financial performance. We seek to achieve our goals with respect to named executive officers compensation by implementing and maintaining incentive plans for such executive officers that tie a substantial portion of each executive s overall compensation to pre-determined financial goals relating to our return on equity and earnings per share.

Committee Process. The compensation committee meets as often as necessary to perform its duties and responsibilities. During 2008, the committee met four times. The compensation committee s meeting agenda is normally established by our Chief Executive Officer in consultation with other members of the committee. Committee members receive the agenda and related materials in advance of each meeting. Depending on the meeting s agenda, such materials may include: financial reports regarding our performance, reports on achievement of individual and company objectives and information regarding our compensation programs.

The compensation committee periodically reviews overall compensation levels to ensure that performance-based compensation represents a sufficient portion of total compensation to promote and reward executive officers contributions to our performance. With respect to our named executive officers, the committee has determined to place increasing emphasis on performance-based compensation in lieu of paying higher base salaries. All members of our compensation committee have extensive experience in the health care industry, including a focus on structuring appropriate executive compensation for health care investment funds and their portfolio companies. In setting the compensation for the named executive officers, our compensation committee members draw on their collective experience in the health care industry and knowledge of investors goals. Accordingly, our compensation committee has not deemed it necessary to review formal compensation data or utilize a formal benchmarking process or the services of a compensation consultant to set the compensation levels of our named executive officers.

Role of Chief Executive Officer and Executive Chairman in Compensation Decisions. Our Chief Executive Officer and Executive Chairman abstain from voting on matters regarding their compensation or any compensation related plans in which they are participants. Our Chief Executive Officer recommends levels of compensation for the other named executive officers. However the compensation committee makes the final determination regarding the compensation of the named executive officers.

Elements of Compensation

Executive compensation consists of the following elements, each of which is discussed in further detail in the sections that follow:

Base Salary

Annual Performance-Based Bonuses

Annual Discretionary Bonuses

Long Term Cash Incentive Plan

Equity Compensation

Perquisites and Personal Benefits

General Benefits

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We have entered into employment contracts with certain of our named executive officers. In addition to the compensation components listed above, these contracts provide for post-employment severance payments and benefits in the event of employment termination under certain circumstances. The named executive officers who do not have employment contracts are party to change in control agreements with Select.

Base Salary

Base salaries are provided to our named executive officers to compensate them for services rendered during the year. Consistent with our philosophy of placing increasing emphasis on performance-based compensation, the compensation committee sets the base salaries for our named executive officers at levels which it believes are competitive for the health care industry when combined with our incentive programs. The compensation committee periodically reviews base salaries for the named executive officers. For 2008, the compensation committee determined that the base salaries for our Chief Executive Officer and our Executive Chairman when combined with the bonus opportunities available under our incentive programs were at competitive levels and that no adjustments were required. The base salary for Ms. Rice, Mr. Jackson and Mr. Fritsch were increased, effective January 1, 2008, to $750,000, $400,000 and $350,000 per year, respectively. The compensation committee determined that the adjustment in salary for these named executive officers for 2008 was appropriate as each officer had not received a salary increase in a number of years. The base salary for Messrs. Rocco and Robert Ortenzio, Ms. Rice, Mr. Jackson and Mr. Fritsch were increased effective April 1, 2009 to $848,720, $848,720, $800,000, $412,000 and $385,000. The compensation committee determined that the adjustment in salary for these named executive officers for 2009 was appropriate based upon the performance and achievements of these individuals in fiscal 2008.

2008 Named Executive Officer Bonuses

Annual cash bonuses are included as part of the executive compensation program because the compensation committee believes that a significant portion of each named executive officer s compensation should be contingent on our financial performance. Accordingly, we maintain a bonus plan under which named executive officers are eligible to receive annual cash bonuses based upon the achievement of specific performance measures.

The compensation committee determines the range of bonus opportunities based on our philosophy that performance-based bonuses should represent a significant portion of overall compensation for the named executive officers. In order to further our philosophy that compensation should reward such executive officers contribution to our financial performance, the bonus plan for such executives is designed to determine bonuses based on measures directly related to our financial performance and the increase in stockholder value.

In 2008, the compensation committee established financial performance targets for the bonus plan for the named executive officers based on our return on equity and earnings per share, the achievement of which would have entitled the named executive officers to receive annual bonuses from 0% to 250% of a target bonus percentage multiplied by the named executive officer s base salary. If both of the performance goals were met, the participants would have received cash bonuses equal to their target bonus percentage listed below times the participant s base salary. If one or both of the performance goals are exceeded, the participants may receive bonuses greater than their target bonus percentage, up to a maximum of 250% of such target bonus percentage multiplied by such participant s base salary, depending upon the extent to which the performance goals were exceeded. For example, a participant whose target bonus percentage is 50% is eligible to receive a bonus equal to 125% of the participant s base salary if the maximum cash award of 250% is achieved (i.e., 250% times 50% equals 125%).

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For the 2008 fiscal year, the compensation committee established the following goals, both of which needed to be attained to entitle the executive to receive a cash payment equal to the stated bonus percentage times the executive s base salary: return on equity of at least 10.2% and earnings per share of at least $0.16. The targets were determined based on our annual budget, which our compensation committee determined was a desirable level of annual performance for our company. For 2008, the target bonus percentage for each of the named executive officers eligible to participate in the bonus plan is set forth in the table below. The target bonus percentage for Messrs. Rocco and Robert Ortenzio exceeds the target bonus percentages for the other named executive officers due to a higher level of responsibility.

Named Executive Officer	Target Bonus (% of Base Salary)
Rocco A. Ortenzio	80%
Robert A. Ortenzio	80%
Patricia A. Rice	50%
Martin F. Jackson	50%
S. Frank Fritsch	50%

Our financial performance goals for 2008 for return on equity and earnings per share were not attained. Accordingly, none of the named executive officers listed in the table above received performance-based bonuses for fiscal year 2008 under the bonus plan.

The compensation committee also has the authority to award bonuses to our executives on a purely discretionary basis. For 2008, the compensation committee determined that as a result of our 2008 financial results and other performance factors, a group of eight senior executives (including our named executive officers) should receive an aggregate bonus of $2.9 million to be allocated among such executives. The other performance factors considered by the compensation committee were our having adapted to an increasingly difficult and complex regulatory environment, management s work with industry and government officials on regulations affecting our business, improvements in our cost management and our senior executive officers having positioned our company to undertake an initial public offering. The compensation committee believed that the designated return on equity and earnings per share targets were not attained, in part, because of changes in regulatory reimbursement rates that were beyond the control of our senior executive officers. Therefore, in light of the other performance factors described above and the fact that our 2008 earnings were consistent with our budgeted goals, each member of the senior management team, including Mr. Jackson, would receive a bonus of at least 60% of such senior executive officer s base salary.

The compensation committee further determined that discretionary bonuses in excess of 60% of base salary were appropriate for four of our named executive officers based on their contributions to our company in 2008. Based on Mr. Rocco Ortenzio s and Mr. Robert Ortenzio s experience in our industry and in keeping with our company s historical practice, the compensation committee had set each of their 2008 bonus targets at a minimum of 80% of base salary. Even though our company s designated performance goals were not attained, the compensation committee determined that a discretionary bonus at the historical level of 80% of their base salary was appropriate for each of Mr. Rocco Ortenzio and Mr. Robert Ortenzio based on their leadership and individual contributions to our company s achievement of its financial results and the other performance factors described above. The compensation committee determined that Ms. Rice should also receive a bonus of 80% of her base salary because the compensation committee believed that Ms. Rice s contribution to our company s achievement of financial results and the other performance factors described above was commensurate with the contributions of our company s Chief Executive Officer and Executive Chairman. The compensation committee determined to pay Mr. Fritsch a bonus of 75% of his base salary based on the compensation committee s subjective assessment of his performance for the 2008 fiscal year, including

his development of professional tools to assist our employees in assimilating to our culture and implementation of succession planning initiatives and leadership training programs. Accordingly, the compensation committee granted discretionary bonuses of $660,000 to Mr. Rocco Ortenzio (representing 80% of his base salary), $660,000 to Mr. Robert Ortenzio (representing 80% of his base salary),

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$600,000 to Ms. Rice (representing 80% of her base salary), $240,000 to Mr. Jackson (representing 60% of his base salary) and $260,000 to Mr. Fritsch (representing 75% of his base salary).

2009 Named Executive Officer Bonuses

For the 2009 fiscal year, the compensation committee determined that only discretionary bonuses, rather than bonuses based on pre-determined financial goals, would be awarded based on the compensation committee s assessment of our company s financial results, each named executive officer s individual performance, and such other factors as the compensation committee may consider relevant. For 2009, the target bonus percentage for each of the named executive officers eligible to participate in the bonus plan is set forth in the table below. The target bonus percentages for Messrs. Rocco and Robert Ortenzio and Ms. Rice exceeds the target bonus percentages for the other named executive officers due to a higher level of responsibility.

Named Executive Officer	Target Bonus (% of Base Salary)
Rocco A. Ortenzio	80%
Robert A. Ortenzio	80%
Patricia A. Rice	80%
Martin F. Jackson	50%
S. Frank Fritsch	50%

Long Term Cash Incentive Plan

All of our named executive officers are eligible to participate in our Long Term Cash Incentive Plan, which we refer to as the Cash Plan. The Cash Plan was adopted to promote our long term financial interests and to enhance long term stockholder value. The Cash Plan achieves these goals by aligning the interests of the named executive officers with those of our stockholders through grants of notional units which are held in a bookkeeping account for each applicable participant until paid to such participant, generally upon the occurrence of certain liquidity events described below. Prior to payment, except in the event of death or disability, as discussed below, no participant has any right to receive any amount with respect to his or her account and the units held therein vested. Through the Cash Plan, we seek to provide an incentive to such officers and to motivate them to assist our current stockholders in achieving their long term goal, which is a liquidity event.

The Cash Plan originally provided a bonus pool of $100.0 million, to be paid on a pro rata basis to all participants according to the number of units held in their accounts. Fifty percent of the bonus pool may be allocated to participants accounts and paid upon the earlier to occur of a change in control of our company or an initial public offering of our company, in either case, that satisfies certain conditions (described below), neither of which are expected to be satisfied upon the consummation of this offering. In order for any portion of the bonus pool to be allocated and paid upon a change in control or an initial public offering, the value of one share of our preferred stock and 6.75 shares of our common stock, or a Strip of Securities, must be in excess of the greater of (1) $67.25 and (2) the value required for a Strip of Securities to yield a 25% average annual percentage return, compounded annually, from the adoption of the Cash Plan through the date of the initial public offering or change in control, as applicable. The remaining 50% of the bonus pool may be allocated and paid upon a redemption of our preferred stock, when special dividends are paid on our preferred stock or upon a sale of our outstanding preferred stock within the twelve-month period following an initial public offering. The amounts that may be payable under the Cash Plan in such event(s) are calculated by multiplying $50.0 million, less all prior amounts paid under the Cash Plan as a result of such special dividend or sale of preferred stock, by a percentage equal to the accreted value received by preferred

stock holders divided by the total accreted value of preferred stock. Common stock received from the conversion of our preferred stock in connection with this offering will not be considered a redemption for purposes of the Cash Plan and accordingly will not trigger payments thereunder.

On September 29, 2005, we made a payment of $14.2 million, in the aggregate, to participants in the Cash Plan as a result of a special dividend paid to holders of our preferred stock with the proceeds of our $175.0 million senior floating rate notes. Following this payment, $85.8 million remained to be allocated to participants accounts. No other payments have been made under the Cash Plan.

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The term change in control generally means (1) the disposition of all or substantially all of our assets, (2) the acquisition by any person of beneficial ownership of more than 40% of the voting power of our company or (3) a change in the majority of the members of our board of directors. The term initial public offering generally means an initial public offering in which we receive proceeds, which when combined with the proceeds received by our company in all prior public offerings, exceed $250.0 million. This offering will be considered an initial public offering for purposes of the Cash Plan.

Under the terms of the Cash Plan, all units held in a participant s account will be forfeited by the participant in the event of his or her termination of employment other than by reason of death or disability. However, in the event of a participant s termination of employment by reason of death or disability, 50% of the units in his or her account will be forfeited and the remaining units will remain in the account and be payable to the participant on January 31st of the second year following his or her disability or death.

Until the occurrence of an event that would trigger the payment of cash on any outstanding units held in participants accounts is deemed probable by us, no expense for any award under the Cash Plan will be reflected in our financial statements. Because we have not altered the allocation of units previously established and disclosed, and because no event entitling named executive officers to payment under the Cash Plan occurred in 2008, there is no amount reported in the Summary Compensation Table below regarding the Cash Plan.

The number of units allocated to the account of each of the named executive officers is set forth in the table below. The number of units allocated to the accounts of Messrs. Rocco and Robert Ortenzio exceeds the number of units allocated to the other named executive officers due to a higher level of responsibility.

Named Executive Officer	**Cash Plan Units**
Rocco A. Ortenzio	25,000
Robert A. Ortenzio	35,000
Patricia A. Rice	15,000
Martin F. Jackson	7,000
S. Frank Fritsch	5,000

As described more fully in the Section below entitled Potential Payments upon Termination or Change in Control the named executive officers would be entitled to approximately $74,608,212 million under the Cash Plan upon completion of our initial public offering if the value of or return on a Strip of Securities equals or exceeds the targets stated in the Cash Plan and all of our preferred stock is redeemed for payment in full of its accreted value.

As discussed above, the targets stated in the Cash Plan have not been satisfied however, and the $50.0 million bonus payable upon an initial public offering or change in control will not be paid.

Our board of directors amended the Cash Plan, effective August 20, 2008. This amendment provided for an additional payment from the bonus pool (not to exceed $10.0 million) upon the completion of an initial public offering prior to March 31, 2009 if the amount of the bonus pool payable as a result of the redemption of preferred stock in connection with such offering did not result in full payment of the amount remaining in that bonus pool ($35.8 million). Because this offering was not completed prior to March 31, 2009, no payments were required to be paid under the Cash Plan due to this amendment.

Our board of directors further amended the Cash Plan, effective August 12, 2009, to provide for a payment under the Cash Plan of $18,000,000 upon the completion of this initial public offering on or prior to March 31, 2010. Each

participant s payment upon such an event would be equal to the product of (1) $18,000,000 and (2) the number of units held by such participant, divided by the total number of units outstanding under the Cash Plan. Following any such payment, all units under the Cash Plan will be forfeited and no participant will be entitled to any further

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benefit or payment under the Cash Plan. If this offering is completed on or before March 31, 2010, each of the named executive officers will receive the following payments under the Cash Plan:

Named Executive Officer	Cash Plan Payment
Rocco A. Ortenzio	$ 4,500,000
Robert A. Ortenzio	$ 6,300,000
Patricia A. Rice	$ 2,700,000
Martin F. Jackson	$ 1,260,000
S. Frank Fritsch	$ 900,000

Equity Compensation

In connection with us becoming a privately owned corporation in 2005, described in Business The Merger Transactions, we sought to encourage meaningful long term contribution to our future financial success by our named executive officers. Accordingly, we established the 2005 Equity Incentive Plan, or Equity Plan, to provide certain of our employees, including our named executive officers, and employees of our subsidiaries with incentives to help align those employees interests with the interests of our stockholders. Awards under the Equity Plan vest over a period of time based on the applicable employee s continued employment.

Awards under the Equity Plan may be in the form of restricted stock, non-qualified stock options and incentive stock options. As of the end of our last completed fiscal year, the named executive officers have been granted only awards of restricted stock under the Equity Plan. The terms of each award granted under the Equity Plan are governed by the Equity Plan and the applicable award agreement between us and the recipient. Under the terms of the award agreements with each of our named executive officers, upon the occurrence of (1) a change in control, all unvested shares of restricted stock will immediately vest in full and (2) an initial public offering, 50% of the then unvested shares of restricted stock will immediately vest. The terms change in control and initial public offering have the same meanings as in Long Term Cash Incentive Plan, above.

Except with respect to Ms. Rice, all of the unvested shares of restricted stock granted to a named executive officer will be forfeited in the event of his or her termination of employment with us and all of our subsidiaries for any reason. Ms. Rice s award agreement was amended on February 13, 2008 to provide that in the event that her employment is terminated by us without cause, or if she dies or becomes disabled while employed by us, all of her then unvested shares of restricted stock will immediately vest in full. The amendments to the vesting provisions were provided to Ms. Rice to further incentivize her to remain employed with our company.

No grants were made to our named executive officers under the Equity Plan in 2008 based on the compensation committee s determination that the named executive officers possess a sufficient ownership interest in us and are sufficiently motivated by our bonus compensation programs to continue to contribute to our financial performance.

The compensation committee granted restricted stock under the Equity Plan to the participants in our Long Term Cash Incentive Plan, including our named executive officers, on August 12, 2009. Pursuant to the terms of the restricted stock award agreements entered into with each named executive officer, the restricted shares vest and become transferable only if the named executive officer remains continuously employed by us and this offering is consummated on or before March 31, 2010. Each named executive officer was granted the following number of restricted shares on August 12, 2009: Mr. Rocco A. Ortenzio 90,902, Mr. Robert A. Ortenzio 127,263, Ms. Rice 54,541, Mr. Jackson 25,453 and Mr. Fritsch 18,180.

Perquisites and Other Personal Benefits

We provide named executive officers with perquisites and other personal benefits that we and the compensation committee believe are reasonable and consistent with our overall compensation program to better enable us to attract and retain highly skilled named executive officers. The compensation committee periodically reviews the levels of perquisites and other personal benefits provided to named executive officers.

The primary perquisite and personal benefit the named executive officers are provided is the personal use of our aircraft at our expense. In recognition of their contributions to us, Messrs. Rocco and Robert Ortenzio and Ms. Rice are entitled to use our aircraft for personal reasons and may be accompanied by friends and family members. Messrs. Rocco and Robert Ortenzio and Ms. Rice must recognize taxable compensation for the value of

the personal use of our aircraft by themselves and their friends and family members. Messrs. Jackson and Fritsch, along with other executive officers, may use our aircraft in connection with a personal emergency or bereavement matter with the prior approval of our Executive Chairman or Chief Executive Officer.

We offer full reimbursement for the costs associated with an annual comprehensive physical exam for certain executive officers, including travel and accommodations, so that an executive officer who makes use of our physical exam benefit can be evaluated and receive diagnostic and preventive medical care.

If Ms. Rice retires prior to age 65, we have agreed to provide continued health and dental insurance benefits to Ms. Rice and her eligible dependents following her retirement until she attains age 65. Ms. Rice would be required, during the period that we provide such health and dental insurance benefits, to make contributions toward the cost of such coverage at the same level required for employees who participate in our health and dental coverage.

Attributed costs of the perquisites and personal benefits described above for the named executive officers for the fiscal year ended December 31, 2008, are included in the Summary Compensation Table.

General Benefits

Our named executive officers are also eligible to participate in our group health and dental plans, including short term and long term disability, life insurance (at an amount up to 100% of base salary), and our 401(k) plan on the same terms and conditions as those plans are available to our employees generally.

Employment Agreements

It is our general philosophy that all our employees should be at will employees, thereby allowing both us and the employee to terminate the employment relationship at any time and without restriction or financial obligation. However, in certain cases, we have determined that as a retention device and as a means to obtain non-compete arrangements, employment agreements and change in control agreements are appropriate.

Messrs. Rocco and Robert Ortenzio and Ms. Rice each entered into an employment agreement with Select on March 1, 2000. Each of these employment agreements provides for a three year term which is automatically extended for an additional year on each anniversary of the effective date of the employment agreements unless a written notice of non-renewal is provided by either party at least three months prior to the applicable anniversary date. This automatic renewal provision has the effect of causing these employment agreements to have a continuous three year term. In addition to the compensation and benefits described above, these contracts provide for certain post-employment severance payments in the event of employment termination under certain circumstances.

Each agreement provides for severance upon termination of employment following a change in control, as described under the Section titled Potential Payments upon Termination or Change in Control below. In addition, upon a termination by us without cause or for good reason, such agreements require us to pay each such executive a pro-rated bonus for the year of termination and an amount equal to the base salary they would have received over the remainder of the term had no such termination occurred, provided that such executive adheres to the restrictive covenants contained in such agreement.

The employment agreements were amended effective December 31, 2008 to comply with the requirements of Section 409A of the Internal Revenue Code (the Code). Severance benefits under the employment agreements, as amended, may be delayed for six months following a termination of employment if necessary and a pro-rated bonus is payable in the event of certain terminations in connection with a change of control. The terms of these agreements, including the severance benefits owed under these agreements, are described more fully in the section titled Potential

Payments upon Termination or Change in Control below.

Messrs. Jackson and Fritsch are employees-at-will, and accordingly, elements of their annual compensation are subject to review and adjustment by the compensation committee. However, Messrs. Jackson and Fritsch are each a party to change in control agreements with Select which provide for severance upon the termination of employment in connection with a change in control.

The change in control agreements were amended effective December 31, 2008 to comply with Section 409 of the Code. Severance benefits under the change in control agreements, as amended, may be delayed for a period of six months following a termination of employment if necessary. The terms of these agreements, including the

payments owed thereunder, are described more fully in the section titled Potential Payments upon Termination or Change in Control below.

Rocco A. Ortenzio

Select and Mr. Rocco A. Ortenzio, our co-founder, are parties to an employment agreement, dated as of March 1, 2000, as subsequently amended, which is currently effective. Pursuant to the terms of his employment agreement, Mr. Rocco A. Ortenzio is entitled to an annual base salary of $800,000, subject to adjustment by our board of directors. Mr. Rocco A. Ortenzio s annual base salary was subsequently upwardly adjusted by the board of directors on multiple occassions and was last adjusted to $848,720 effective April 1, 2009.

Mr. Rocco A. Ortenzio is also eligible for bonus compensation under his employment agreement, however our bonus plan for certain executive officers, described in the Compensation Discussion and Analysis section above, is the primary mechanism for determining bonus compensation from us for Mr. Rocco A. Ortenzio.

Mr. Rocco A. Ortenzio s employment agreement also provides that if he is terminated due to his disability, we must make salary continuation payments to him equal to 100% of his annual base salary for ten years after his date of termination or until he is physically able to become gainfully employed in an occupation consistent with his education, training and experience.

Mr. Rocco A. Ortenzio is entitled to up to six weeks paid vacation per year under the terms of his employment agreement.

Robert A. Ortenzio

Select and Mr. Robert A. Ortenzio, our co-founder, are parties to an employment agreement, dated as of March 1, 2000, as subsequently amended, which is currently effective. Pursuant to the terms of his employment agreement, Mr. Robert A. Ortenzio is entitled to an annual base salary of $800,000, subject to adjustment by our board of directors. Mr. Robert A. Ortenzio s annual base salary was subsequently upwardly adjusted by the board of directors on multiple occassions and was last adjusted to $848,720 effective April 1, 2009.

Mr. Robert A. Ortenzio is also eligible for bonus compensation under his employment agreement, however our bonus plan for certain executive officers, described in the Compensation Discussion and Analysis section above, is the primary mechanism for determining bonus compensation from us for Mr. Robert A. Ortenzio.

Mr. Robert A. Ortenzio s employment agreement also provides that if he is terminated due to his disability, we must make salary continuation payments to him equal to 50% of his annual base salary for ten years after his date of termination or until he is physically able to become gainfully employed in an occupation consistent with his education, training and experience.

Mr. Robert A. Ortenzio is entitled to up to six weeks paid vacation per year under the terms of his employment agreement.

Patricia A. Rice

Select and Ms. Rice are parties to an employment agreement, effective as of March 1, 2000, as subsequently amended, which is currently effective. Pursuant to the terms of her employment agreement, Ms. Rice serves as our President and Chief Operating Officer and is entitled to an annual base salary of $500,000, subject to adjustment by our board of directors. Ms. Rice s annual base salary was subsequently upwardly adjusted by the board of directors on multiple

occassions and was last adjusted to $800,000 effective April 1, 2009.

On February 13, 2008, Select entered into Amendment No. 6 to the Employment Agreement between Select and Ms. Rice. The amendment provides as follows: (1) Ms. Rice, in carrying out her duties, may use her office in Mechanicsburg, Pennsylvania and/or her home offices in Nicholasville or Lexington, Kentucky and St. Petersburg, Florida, (2) Ms. Rice s base salary was increased to $750,000 per year, (3) Ms. Rice will receive benefits under Select s Paid Time Off (PTO) & Extended Illness Days (EID) policy in effect from time to time, and (4) Ms. Rice, following a change of control of Select, will be entitled to receive the change of control benefits provided for under the Employment Agreement if, within the one-year period immediately following such change of control, Ms. Rice s employment with Select (1) is terminated by Select without cause, or (2) is terminated by Ms. Rice for any reason. Also on February 13, 2008, we entered into Amendment No. 1 to Restricted Stock Award Agreement with Ms. Rice. The Award Agreement Amendment provides that if during the course of Ms. Rice s employment

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with Select, Ms. Rice shall die, become disabled or be terminated by Select without cause, then all restricted periods shall terminate, all restricted stock shall be vested in full and all limitations on the restricted stock shall automatically lapse.

Ms. Rice is also eligible for bonus compensation under her employment agreement, however our bonus plan for certain executive officers, described in the Compensation Discussion and Analysis section above, is the primary mechanism for determining bonus compensation from us for Ms. Rice.

Ms. Rice s employment agreement also provides that if she is terminated due to her disability, we must make salary continuation payments to her equal to 50% of her annual base salary for ten years after her date of termination or until she is physically able to become gainfully employed in an occupation consistent with her education, training and experience.

Finally, as described in the Compensation Discussion and Analysis section, above, if Ms. Rice retires before the age of 65, she is entitled to our health and dental insurance coverage for herself and her eligible dependents, following her retirement until she attains age 65. Ms. Rice would be required to contribute to the cost of such coverage at the same level required for employees who participate in our health and dental coverage.

Summary Compensation Table

This Summary Compensation Table summarizes the total compensation paid or earned by each named executive officer for each of the 2008, 2007 and 2006 fiscal years.

Name & Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)(1)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value ($)	All Other Compensation ($)(2)	Total Compensation ($)
Rocco A. Ortenzio	2008	824,000	660,000					120,106	1,604,106
Executive Chairman	2007	824,000	229,000					132,451	1,185,451
	2006	824,000						137,605	961,605
Robert A. Ortenzio	2008	824,000	660,000	1,003,623				58,657	2,546,280
Chief Executive	2007	824,000	229,000	2,604,033				108,077	3,765,110
Officer	2006	824,000		2,604,032				150,040	3,578,072
Patricia A. Rice	2008	743,933	600,000	444,617				197,428	1,985,978
President and Chief	2007	592,250	164,645	444,618				234,555	1,436,068
Operating Officer	2006	592,250		444,617				158,230	1,195,097
Martin F. Jackson	2008	398,897	240,000	222,309				6,900	868,106
Executive Vice	2007	371,315	103,225	222,309				28,216	725,065
President and Chief Financial Officer	2006	371,315	50,000	222,309				6,600	650,224
S. Frank Fritsch	2008	347,148	260,000	77,067				5,750	689,965
Executive Vice	2007	275,834	76,680	77,067				5,625	435,206
President and Chief Human Resources Officer	2006	275,834	50,000	77,067				5,500	408,401

(1) The dollar amounts reported in this column represent the expense recognized by us in accordance with Statements of Financial Accounting Standards No. 123R, Share-Based Payment (FAS 123R) on outstanding restricted stock awards granted pursuant to the 2005 Equity Incentive Plan. No such expense was recorded for Mr. Rocco Ortenzio s award because the restricted stock award was fully vested prior to 2006. See Note 10 to the Consolidated Financial Statements included in this prospectus for a discussion of the relevant assumptions used in calculating value pursuant to FAS 123R. See also the Option Exercises and Stock Vested Table, which shows the corresponding number of shares vesting under each such restricted stock award with respect to which we recognized an expense under FAS 123R.

(2) Mr. Robert A. Ortenzio, Ms. Rice and Mr. Jackson each received an employer matching contribution to our 401(k) plan in the amount of $6,900 in 2008, $6,750 in 2007 and $6,600 in 2006. Mr. Fritsch received a matching contribution of $5,750 in 2008, $5,625 in 2007 and $5,500 in 2006. The other items reported in this column include the value of personal use of our aircraft and the incremental cost to us of the executive s participation in our executive physical exam program, each in the amounts set forth in the Personal Benefits table below. The

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incremental cost to us of each of the personal benefits for Mr. Jackson in 2008 and for Mr. Fritsch in both 2008 and 2007 did not exceed $10,000, and accordingly, are not described below.

Personal Benefits

Name		Aircraft Usage ($)	Executive Physical ($)
Rocco A. Ortenzio	2008	120,106	
Robert A. Ortenzio	2008	51,757	
Patricia A. Rice	2008	190,528	
Martin F. Jackson	2008		

Grants of Plan-Based Awards

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards[(1)]		
Name	Grant Date	Threshold	Target ($)	Maximum ($)
Rocco A. Ortenzio			659,200	1,648,000
Robert A. Ortenzio			659,200	1,648,000
Patricia A. Rice			375,000	937,500
Martin F. Jackson			200,000	500,000
S. Frank Fritsch			175,000	437,000

(1) The amounts in this table represent the target and maximum payouts that could have been achieved by our named executive officers if the financial performance goals for 2008, described above under the heading 2008 Annual Performance-Based Bonuses, were attained. None of the named executive officers received payments of these amounts.

Outstanding Equity Awards at Fiscal Year End Table

	Stock Awards			
	Number of Shares or Units	Market Value of Shares or Units of Stock	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or

Name	of Stock That Have Not Vested (#)	That Have Not Vested ($)[1]	Rights That Have Not Vested (#)	Other Rights That Have Not Vested (#)
Rocco A. Ortenzio				
Robert A. Ortenzio				
Patricia A. Rice	457,655	4,576,550		
Martin F. Jackson	228,828	2,288,280		
S. Frank Fritsch	79,327	793,270		

(1) The values shown in this column are equal to the initial public offering price of $10.00 per share multiplied by the number of shares of stock held by our named executive officers that had not vested as December 31, 2008.

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Option Exercises and Stock Vested Table

Name	Stock Awards Number of Shares Acquired on Vesting (#)	Value Realized on Vesting ($)[1]
Rocco A. Ortenzio		
Robert A. Ortenzio	6,151,853	61,518,530
Patricia A. Rice	1,503,853	15,038,530
Martin F. Jackson	751,927	7,519,270
S. Frank Fritsch	260,668	2,606,680

(1) Values shown in this column are equal to the initial public offering price of $10.00 per share multiplied by the number of shares vested during the year ended December 31, 2008.

Potential Payments upon Termination or Change in Control

Named executives who are party to an employment agreement or a change in control agreement with Select may be entitled to certain payments upon termination of employment or a change in control, as described below. In addition, pursuant to the terms of the Cash Plan, upon an initial public offering of our company (as well as upon certain other events), each of our named executive officers who participates in the Cash Plan is entitled to payment of a portion of the value of his or her units, as described below.

Termination of Employment

Pursuant to the employment agreements between Select and Messrs. Robert and Rocco Ortenzio and Ms. Rice upon a termination of employment by us without cause or by the executive officer for good reason, and except with respect to certain terminations in connection with a change in control, each such officer is entitled to receive (1) immediate vesting of any unvested stock options outstanding prior to such termination of employment, (2) a pro-rated bonus for the year of termination and (3) an amount equal to the base salary he or she would have received over the remainder of the employment term had no such termination occurred, with such amount to be paid in installments for the remainder of the term of the executive s employment agreement, beginning on the six-month anniversary of such termination of employment. As a condition to receiving such payments, however, each executive has agreed that for the term of the agreement and for two years thereafter, the executive may not participate in any business that competes with us within a 25 mile radius of any of our hospitals or outpatient rehabilitation clinics. The executive also may not solicit any of our employees for one year after the termination of the executive s employment.

The employment agreements also entitle the executive officers to receive salary continuation in the event of termination of employment by reason of disability, at the rate of 100% of base salary for Mr. Rocco Ortenzio, and 50% of base salary for each of Mr. Robert Ortenzio and Ms. Rice. Such salary continuation is payable for a period of up to ten years, subject to earlier termination if the executive becomes physically able to resume employment in an occupation consistent with his or her education, training and experience. In addition, in the event of death or disability, the named executive officers are also entitled to retain 50% of the units in their accounts under the Cash Plan. However, we are not required to make any payments following such death or disability until January 31st of the

second year following such death or disability. If this offering is consummated on or prior to March 31, 2010, none of the participants will have any further rights under the Cash Plan.

In addition, any unvested restricted stock held by Ms. Rice will vest in full upon her termination by us without cause or due to her death or disability. Unvested restricted stock held by the other named executive officers will be forfeited upon their termination of employment with us for any reason.

In addition to the payments described above, in the event of Ms. Rice s retirement prior to age 65, she is entitled to continued health and dental benefits for herself and her eligible dependents until she attains age 65.

Set forth in the table below are the amounts that would be payable to each of the named executive officers who is party to an employment contract upon termination of employment for the reasons specified therein, assuming that such termination occurred on December 31, 2008.

	Without Cause/Good Reason		**Disability**			**Death**		**Retirement**
Name	**Base Salary and Bonus ($)**	**Equity Vesting Value[(1)] ($)**	**Base Salary Continuation[(2)] ($)**	**Equity Vesting Value[(1)] ($)**	**Other[(3)] ($)**	**Equity Vesting Value[(1)] ($)**	**Other[(3)] ($)**	**Health and Dental Benefits[(4)] ($)**
Rocco A. Ortenzio	3,269,334		8,240,001		10,719,140		10,719,140	
Robert A. Ortenzio	3,269,334		4,120,000		15,006,795		15,006,795	
Patricia A. Rice	2,955,788	4,576,550	3,719,665	4,576,550	6,431,484	4,576,550	6,431,484	9,876

(1) Valuation is based on the initial public offering price of $10.00 per share.

(2) The amount reported in this column represents the amount of salary continuation payable each year for ten years following the date of termination of employment for disability, subject to termination if the named executive officer becomes physically able to resume employment.

(3) Represents the value of 50% of the units in such named executive officers account under the Cash Plan as of the date of death or disability. Such payments will be due on January 31st of the second year following such death or disability only in the event of an initial public offering, change of control, or preferred stock liquidity event as defined under the Cash Plan.

(4) The value reported in this column reflects our current cost of providing health and dental coverage to Ms. Rice and her eligible dependents for one year. We are responsible for paying the costs of health and dental coverage for Ms. Rice and her eligible dependents (less her portion of the premiums) each year until Ms. Rice reaches the age of 65 in the event she retires before age 65. The actual cost to us of providing such benefits following Ms. Rice s retirement will depend on the rates of the carrier selected and accordingly, may be more or less than the amount reported.

Change in Control

Messrs. Rocco and Robert Ortenzio s and Ms. Rice s employment agreements provide for severance benefits if (1) within the one-year period immediately following a change in control, Messrs. Rocco or Robert Ortenzio or Ms. Rice is terminated by us without cause or any such executive officer terminates his or her employment for any reason or (2) within the six-month period immediately preceding a change in control of our company, Messrs. Rocco or Robert Ortenzio or Ms. Rice is terminated by us without cause and the terminated officer reasonably demonstrates that their termination was at the request of a third party who took steps to effect the change in control. In the event of a termination of employment described in clause (1), such officers are entitled to receive, in lieu of all other severance benefits, a lump-sum cash payment equal to their base salary plus bonus for the previous three completed calendar

years, with such payment to be made on the first payroll date of the seventh month following such termination and immediate vesting of all unvested stock options that were outstanding prior to such termination. In the event of a termination of employment described in clause (2), such officers are entitled to receive a pro rated bonus for the year of termination and, beginning on the six-month anniversary of such termination and in lieu of any continued base salary they may otherwise be entitled to receive, an amount equal to their base salary and bonus for the previous three completed calendar years, with such amount to be paid in installments for the remainder of the term of such executive s employment agreement.

We have entered into change in control agreements with Martin F. Jackson and S. Frank Fritsch. These agreements provide that if (1) within a five year period immediately following a change in control of our company, we terminate Mr. Jackson or Mr. Fritsch without cause, Mr. Jackson or Mr. Fritsch terminates his employment with us because we reduced his compensation from that in effect prior to the change in control or we relocate Mr. Jackson s or Mr. Fritsch s principal place of employment to a location more than 25 miles from Mechanicsburg, Pennsylvania or (2) within the six month period immediately preceding the change in control of our company, Mr. Jackson or Mr. Fritsch terminates his employment for good reason or we terminate Mr. Jackson s or Mr. Fritsch s employment without cause and the terminated officer reasonably demonstrates that his termination by us was at the request of a third party who took steps to effect the change in control, we are obligated to pay the terminated officer, on the first day of the seventh month following such termination, a lump sum cash payment equal to his base salary plus bonus for the previous three completed calendar years and to fully vest the terminated officer s stock options.

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For purposes of the agreements described above, a change in control is generally defined to include: (1) the acquisition by a person or group, other than certain controlling stockholders, of more than 50% of the voting shares of us or Select; (2) during any twelve month period, the acquisition of at least 33% of the voting shares of us or Select; (3) during any twelve month period, there is a change in the majority of the board of directors of us or Select; (4) a business combination of us or Select in which the stockholders of the corporation involved in the business combination cease to own shares representing more than 50% of the voting power of the surviving corporation; or (5) during any twelve month period, a sale of all or substantially all the assets of us or Select, other than to an entity controlled by the stockholders of the selling corporation prior to the sale. Notwithstanding the foregoing, no change of control will be deemed to have occurred unless the transaction provides a specified level of consideration to the stockholders.

Each named executive officer who has been granted restricted stock that is not fully vested as of a change in control or qualified public offering is also entitled to accelerated vesting. In the event of a qualified public offering, 50% of the then-unvested restricted stock would vest and, in the event of a change in control, 100% of the then-unvested restricted stock would vest. Under Ms. Rice s restricted stock award agreement, all of her unvested shares of restricted stock would immediately and fully vest in the event she dies or becomes disabled while employed by us, or if her employment is terminated by us without cause.

Pursuant to the terms of the Cash Plan, upon the earlier to occur of a change in control or an initial public offering in which the proceeds received by us exceed $250.0 million, each named executive officer will receive a payment of $500 with respect to each of the units held in his or her account. In order to receive such payment, the value of a Strip of Securities must be in excess of certain pre-determined levels, as described above in Long Term Cash Incentive Plan. If payment under the Cash Plan is made by reason of a change in control or such initial public offering, the named executive officers will continue to hold the units in their accounts and will be entitled to receive additional payments with respect to such units under the terms of the Cash Plan in the event that our preferred stock is redeemed, a special dividend is paid with respect to our preferred stock or upon the sale of our outstanding preferred stock within the 12-month period following an initial public offering. Such remaining amounts would be calculated as each participant s allocable share of the $35.8 million remaining available under the Cash Plan.

However, because it is not expected that the value of a Strip of Securities at the time of the initial public offering will exceed the value necessary to provide for payment upon such initial public offering, we amended the Cash Plan to provide an incentive to participants to consummate an initial public offering. Pursuant to such amendment, in the event that an initial public offering is consummated on or prior to March 31, 2010, each named executive officer will receive a payment under the Cash Plan equal to the product of (1) $18,000,000 and (2) the number of units held by such named executive officer, divided by the total number of units outstanding under the Cash Plan. Following such payment, none of the participants (including the named executive officers) will have any further rights under the Cash Plan.

In addition to the benefits described above, each named executive officer is entitled to receive a tax gross-up payment in the event that any change in control payments which they are entitled to receive constitute excess parachute payments within the meaning of Section 280G of the Internal Revenue Code. The tax gross-up payment will equal the amount necessary to place the named executive officer in the same position as if no penalty under Section 4999 of the Internal Revenue Code had been imposed on any of the change in control payments, including on the tax gross-up payment.

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Set forth in the table below are the amounts that would be payable to each of the named executive officers upon a change in control, assuming that such change in control occurred on December 31, 2008.

Name	Base Salary and Bonus ($)	Equity Vesting (100%)(1) ($)	Cash Plan Payout(2) ($)	Tax Gross- Up(1) ($)
Rocco A. Ortenzio	3,361,000		21,438,279	
Robert A. Ortenzio	3,361,000		30,013,591	
Patricia A. Rice	2,693,078	4,576,550	12,862,968	1,408,410
Martin F. Jackson	1,534,752	2,288,280	6,002,718	
S. Frank Fritsch	1,285,696	793,270	4,287,656	497,691

(1) Market value is based on the initial public offering price of $10.00 per share.

(2) These amounts reflect the maximum payments that could be made from the Cash Plan. As discussed in the Compensation Discussion and Analysis section above, however, the majority of these amounts will not be paid.

Director Compensation Table

The following table shows information concerning the compensation that our non-employee directors earned during the fiscal year ended December 31, 2008.

Name	Fees Earned or Paid in Cash ($)	Stock Awards ($)(1)	Option Awards ($)(2)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Russell L. Carson							
David S. Chernow	32,000		1,057				33,057
Bryan C. Cressey							
James E. Dalton, Jr.	46,000		1,057				47,057
James S. Ely	4,700		656				5,356
Thomas A. Scully		6,817					6,817
Leopold Swergold	47,000		1,057				48,057
Sean M. Traynor							

(1) Represents vesting of restricted shares granted in connection with the Merger Transactions.
(2) The dollar amounts reported in this column represent the FAS 123R expense recognized by us on outstanding option awards (including those made in 2008) granted to non-employee directors pursuant to the Director Plan. The grant date fair market value (calculated in accordance with FAS 123R) of the 3,000 options granted to each of Messrs. Chernow, Dalton, Jr., and Swergold on August 20, 2008, was $12,249. See Note 10 to the Consolidated Financial Statements included in this prospectus for a discussion of the relevant assumptions used in calculating

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value pursuant to FAS 123R. As of December 31, 2008, the total number of outstanding stock and option awards for each director listed in the table above are set forth below:

Name	Shares Outstanding Subject to Stock Awards (#)	Shares Outstanding Subject to Option Awards (#)
Russell L. Carson		
David S. Chernow		15,000
Bryan C. Cressey		
James E. Dalton, Jr.		15,000
James S. Ely		6,000
Thomas A. Scully		
Leopold Swergold		15,000
Sean M. Traynor		

We do not pay directors fees to our employee directors; however they are reimbursed for the expenses they incur in attending meetings of the board of directors or board committees. Non-employee directors other than non-employee directors appointed by Welsh Carson and Thoma Cressey receive cash compensation in the amount of $6,000 per quarter, and the following for all meetings attended other than audit committee meetings: $1,500 per board meeting, $300 per telephonic board meeting, $500 per committee meeting held in conjunction with a board meeting and $1,000 per committee meeting held independent of a board meeting. For audit committee meetings attended, all members receive the following: $2,000 per audit committee meeting and $1,000 per telephonic audit committee meeting. All non-employee directors are also reimbursed for the expenses they incur in attending meetings of the board of directors or board committees.

Option Awards

On August 10, 2005, our board of directors authorized a director equity incentive plan, which we refer to as the Director Plan, for non-employee directors, which was formally approved on November 8, 2005. 75,000 shares of our common stock are reserved for option awards under the Director Plan and following the consummation of this offering 150,000 shares of our common stock will be reserved for restricted stock awards under the Director Plan.

On August 20, 2008, we made discretionary grants of options to acquire 3,000 shares of common stock to each of Messrs. Chernow, Dalton and Swergold pursuant to the Director Plan. Such options vest in equal increments on each anniversary of the grant date for five years.

Compensation Committee Interlocks and Insider Participation

Prior to August, 2009, our compensation committee consisted of Messrs. Carson, Chernow, Cressey, Rocco Ortenzio and Robert Ortenzio. Messrs. Rocco Ortenzio and Robert Ortenzio resigned from our compensation committee in August, 2009. Mr. Carson is affiliated with Welsh Carson and Mr. Cressey is affiliated with Thoma Cressey, both of whom are principal stockholders. See Certain Relationships and Related Transactions for a description of our relationships with Welsh Carson and Thoma Cressey.

None of the members of the compensation committee who will continue to serve on the compensation committee after our common stock has been listed on the New York Stock Exchange is currently or has been at any time one of our officers or employees. None of our executive officers currently serves, or has served during the last completed fiscal

year, as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving as a member of our board of directors or compensation committee. None of our executive officers was a director of another entity where one of that entity s executive officers served on our compensation committee, and none of our executive officers served on the compensation committee or the board of directors of another entity where one of that entity s executive officers served as a director on our board of directors.

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Equity Compensation Plan Information

Set forth in the table below is a list of all of our equity compensation plans and the number of securities to be issued on exercise of equity rights, average exercise price, and number of securities that would remain available under each plan if outstanding equity rights were exercised as of December 31, 2008.

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity compensation plans approved by security holders:			
Select Medical Holdings Corporation 2005 Equity Incentive Plan	1,434,242	$ 6.71	5,339,018
Director equity incentive plan	51,000	$ 7.06	24,000

The Board and the stockholders approved an amendment and restatement of the Select Medical Holdings Corporation 2005 Equity Incentive Plan that will become effective immediately prior to the consummation of this offering. Following such amendment and restatement, approximately 24,169,100 shares will remain available for future issuance under such plan (assuming no new awards are granted under such plan between the date of this filing and the consummation of this offering). In addition, the Board and the stockholders approved an amendment and restatement of the director equity incentive plan that will become effective immediately prior to the consummation of this offering. Following such amendment and restatement, approximately 162,000 shares will remain available for future issuance under such plan (assuming no new awards are granted under such plan between the date of this filing and the consummation of this offering).

Amended and Restated 2005 Equity Incentive Plan

In 2005, our board of directors, or the Board, adopted the Select Medical Holdings Corporation 2005 Equity Incentive Plan, or the Plan. Our Board and stockholders approved an amendment and restatement of the Plan (which is described below) that will become effective immediately prior to the consummation of this offering. The purpose of the Plan is to assist us and our subsidiaries in attracting and retaining qualified employees, directors and consultants and to align their interests with those of our other stockholders, thereby promoting our long-term financial interests. The Plan accomplishes these goals through the grant of awards of restricted stock and options. The Plan, as it will be in effect following its amendment and restatement, is described below.

Summary of the Plan

General. The Plan authorizes the grant of options and restricted stock (collectively, Awards). Options granted under the Plan may be either incentive stock options as defined in section 422 of the Internal Revenue Code of 1986, as amended (the Code), or nonqualified stock options, as determined by the committee appointed by the Board to

administer the Plan (the Committee).

Number of Shares Authorized. Subject to adjustment as described below, the maximum number of shares available for issuance with respect to (1) options shall be 5,317,379 shares, increased by an amount such that the total number of shares available for issuance with respect to options shall be 5,317,379 shares plus 10% of our company s total issued and outstanding shares of common stock in excess of 68,173,794 shares; provided, however, that such increase in shares over the term of the Plan shall not exceed 3,000,000 shares in the aggregate and (2) restricted stock shall not exceed 17,276,723 shares. Accordingly, assuming that the maximum increase described in clause (1) above occurs, the maximum number of shares that may be issued in respect of Awards

over the term of the Plan is 25,594,102 shares. The maximum number of shares that may be delivered in respect of incentive stock options is 7,500,000 shares and the maximum number of shares available for Awards that may be granted to any individual during any calendar year shall not exceed 1,500,000 shares.

If any shares subject to an Award are forfeited or if such Award otherwise terminates or is settled for any reason whatsoever without an actual distribution of shares to the participant, any shares counted against the number of shares available for issuance pursuant to the Plan with respect to such Award will, to the extent of any such forfeiture, settlement, or termination, again be available for Awards under the Plan. In addition, if there is any change in Holdings corporate capitalization, such as a stock split, stock dividend, spinoff, recapitalization, merger, consolidation or the like, the Committee will equitably adjust the aggregate number and class of shares with respect to which Awards may be made under the Plan, as well as the terms, number and class of shares subject to outstanding Awards, provided that no adjustment may be made that would cause the Plan to violate Section 422 of the Code with respect to incentive stock options or that would adversely affect the status of any Award that is performance-based compensation under Section 162(m) of the Code. The Committee may also make adjustments in the terms and conditions of Awards in recognition of unusual or nonrecurring events affecting Holdings or any of its subsidiaries or affiliates, or in response to changes in applicable laws, regulations, or accounting principles; provided, that no such adjustment may be made in any outstanding Awards to the extent that such adjustment would constitute a repricing of any option under the rules of any applicable national securities exchange or would adversely affect the status of the Award as performance-based compensation under Section 162(m) of the Code.

Administration. The Plan is administered by the Committee. The Committee s powers include, but are not limited to, the power to:

select the employees, non-employee directors and consultants who will receive Awards pursuant to the Plan;

determine the type or types of Awards to be granted to each participant;

determine the number of shares to which an Award will relate, the terms and conditions of any Award granted under the Plan and all other matters to be determined in connection with an Award;

determine whether, to what extent, and under what circumstances an Award may be canceled, forfeited, or surrendered;

determine whether, and to certify that, performance goals to which the settlement of an Award is subject are satisfied;

correct any defect, supply any omission or reconcile any inconsistency in the Plan;

adopt, amend and rescind such rules and regulations as, in its opinion, may be advisable in the administration of the Plan;

determine the effect, if any, of a change of control on outstanding Awards; and

construe and interpret the Plan and make all other determinations as it may deem necessary or advisable for the administration of the Plan.

Eligibility. Awards of incentive stock options may be granted only to employees of Holdings and its subsidiaries. Awards of non-qualified stock options and restricted stock may be granted to employees and consultants of Holdings and its subsidiaries and to Holdings non-employee directors.

Each Award granted under the Plan will be evidenced by a written agreement between the holder and Holdings, which will describe the Award and state the terms and conditions applicable to such Award. The principal terms and conditions of each particular type of Award are described below.

Performance Goals

The Committee may provide in an Award agreement that the Award will be earned or vest based on the achievement of performance goals that must be met by the end of the period specified by the Committee (but that is substantially uncertain to be met before the grant of the Award) based upon:

- the price of shares of Holdings stock;
- the market share of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- sales by Holdings, its subsidiaries or affiliates (or any business unit thereof);
- earnings per share of Holdings stock;
- Holdings return on stockholder equity;
- costs of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- cash flow of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- return on total assets of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- return on invested capital of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- return on net assets of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- operating income of Holdings, its subsidiaries or affiliates (or any business unit thereof);
- net income of Holdings, its subsidiaries or affiliates (or any business unit thereof); or
- any other financial or other measurement deemed appropriate by the Committee, as it relates to the results of operations or other measurable progress of Holdings, its subsidiaries or affiliates (or any business unit thereof).

The Committee has discretion to determine the specific targets with respect to each of these categories of performance goals.

Restricted Stock

In a restricted stock Award, the Committee grants to a participant shares of stock that are subject to certain restrictions, including forfeiture of such stock upon the happening of certain events. Shares of stock are issued at the time of grant, but are held by Holdings and delivered to the grantee at the end of the restriction period specified in the Award agreement. During the restriction period, grantees of restricted stock have the right to vote the shares of such stock, and except as may otherwise be provided by the Committee, to receive dividends from such stock.

Options

Options granted under the Plan may be either incentive stock options or non-qualified stock options. The Committee will determine, at the time of grant, the exercise price, the type of option, the term of the option, and the date when the option will become exercisable. Incentive stock options may be granted only to employees of Holdings or its

subsidiaries. No Award of incentive stock options may permit the fair market value of any such options becoming first exercisable in any calendar year to exceed $100,000. Non-qualified stock options may be granted to employees and consultants of Holdings and its subsidiaries, and to non-employee directors of Holdings.

Exercise Price. The Committee will determine the exercise price of an option at the time the option is granted, provided that the exercise price of an option may not be less than 100% (or 110% in the case of an incentive stock option granted to an individual who owns more than 10% of the combined voting power of all classes of Holdings outstanding stock (a 10% Stockholder)) of the fair market value of the stock on the date of grant.

Consideration. The means of payment for shares issued upon exercise of an option will be established by the Committee and may be made by the holder (1) in cash, (2) by delivery of shares of stock having an aggregate fair market value equal to the aggregate exercise price, provided that such shares have been outstanding for at least six

months (unless a shorter period is approved by the Committee), (3) with respect to non-qualified stock option exercises, by irrevocably authorizing a third party acceptable to the Committee to sell the shares of stock acquired upon exercise of the option and to remit a portion of such proceeds to Holdings sufficient to pay the exercise price of such option and to satisfy all applicable withholding taxes or (4) by any other means (including any combination of the foregoing) approved by the Committee.

Term of the Option. The term of an option granted under the Plan will expire upon the earlier of (1) the tenth anniversary of the date of grant (or the fifth anniversary of the date of grant in the case of an incentive stock option granted to a 10% Stockholder), (2) the date established by the Committee at the time of grant, (3) unless otherwise provided by the Committee, the date that is one year after the holder s termination of employment or other service by reason of death or disability, and only with respect to non-qualified stock options, retirement or (4) unless otherwise provided by the Committee, the date that is 90 days after the termination of the holder s employment or other service other than by reason of death or disability, and only with respect to non-qualified stock options, retirement (the Expiration Date).

General Provisions

Issuance of Shares with Respect to Awards. Holdings has no obligation to issue shares of stock under the Plan unless such issuance would comply with all applicable laws and the applicable requirements of any securities exchange or similar entity.

Nontransferability of Awards. In general, during a holder s lifetime, his or her Awards of restricted stock, to the extent such shares remain subject to forfeiture restrictions, and non-qualified stock options are not transferable other than by will or by the laws of descent and distribution or, if permitted by the Committee in the applicable Award agreement, to the holder s immediate family members and certain entities controlled by or benefiting the holder or such family members (Permitted Transferees). Incentive stock options are not transferable other than by will or by the laws of descent and distribution. Options are exercisable during the lifetime of the holder only by the holder or, in the case of a disabled holder, his or her guardian or legal representative. If permitted by the Committee, non-qualified stock options may also be exercised by the holder s Permitted Transferee.

Termination of Employment or Service. All options will be forfeited upon a holder s termination of employment or other service with Holdings and its subsidiaries for cause, and unless the Committee provides otherwise, all unvested options will be forfeited upon a holder s termination of employment or other service with Holdings and its subsidiaries for any reason. Unless the Committee provides otherwise, upon a holder s termination of employment or other service with Holdings and its subsidiaries, vested options may be exercised until their Expiration Date. Except as may otherwise be provided by the Committee, all unvested shares of restricted stock will be forfeited upon a holder s termination of employment or other service with Holdings and its subsidiaries for any reason.

Change of Control

In the event of a change of control, the Committee may, in its discretion, (1) fully vest any or all Awards made under the Plan, (2) cancel any outstanding option in exchange for a cash payment of an amount (including zero) equal to the difference, if any, between the then fair market value of the option less the exercise price of the option; provided that if the Committee determines that the exercise price exceeds the fair market value of the option, the Committee may cancel such option with no further payment due the participant, (3) after having given the participant a reasonable chance to exercise any outstanding options, terminate any or all of the participant s unexercised options, (4) where Holdings is not the surviving corporation, cause the surviving corporation to assume all outstanding Awards or replace all outstanding Awards with comparable awards or (5) take such other action as the Committee determines to be appropriate.

As defined in the Plan, the term change of control means generally:

(i) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or a series of related transactions, of all or substantially all of the properties or assets of Holdings and its subsidiaries or Select Medical Corporation (Select) and its subsidiaries, in either

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case, taken as a whole, to any person (as that term is used in Section 13(d) of the Securities Exchange Act of 1934 (the 1934 Act) other than to certain individuals and entities who had significant ownership of Holdings prior to the offering, as well as certain affiliates and family members of such individuals and entities (Permitted Holders);

(ii) the consummation of any transaction (including, without limitation, any merger or consolidation), the result of which is that any person (as that term is used in Section 13(d) of the 1934 Act), other than Permitted Holders, becomes the beneficial owner, directly or indirectly, of more than 40% of the stock of Holdings or Select that is entitled to vote in the election of directors of such entity (Voting Stock), measured by voting power rather than number of shares, unless the Permitted Holders are the beneficial owners of a greater percentage of the Voting Stock of Holdings or Select, as the case may be; provided, however, that for purposes of this clause (ii), each person will be deemed to beneficially own any Voting Stock of another person held by one or more of its subsidiaries; or

(iii) the first day on which a majority of the members of the Board or the board of directors of Select (the Select Board) are not continuing directors. For purposes of the Plan, a continuing director means, as of any date of determination, any member of the Board or the Select Board who: (1) was a member of such board of directors on the first date Select became a wholly-owned subsidiary of Holdings; (2) was nominated for election or elected to such board of directors with the approval of a majority of the continuing directors who were members of such board of directors at the time of such nomination or election; or (3) was designated or appointed with the approval of Permitted Holders holding a majority of the Voting Stock of all of the Permitted Holders.

Effective Date, Amendments, and Termination of the Plan. The Plan became effective on February 24, 2005. The amendment and restatement of the Plan, which has been described above, was approved by the Board and the stockholders and will become effective immediately prior to the consummation of this offering. Unless earlier terminated by the Board, the Plan will terminate on August 12, 2019. The Board may amend the Plan without the consent of the stockholders or participants, except that any such amendment will be subject to the approval of Holdings stockholders if (1) such action would increase the number of shares of stock subject to the Plan, (2) such action would result in the repricing of any option or (3) such stockholder approval is required by any federal or state law or regulation or the rules of any stock exchange or automated quotation system on which Holdings stock is then listed or quoted. In addition, without the consent of an affected participant, no amendment or termination of the Plan may materially and adversely affect the rights of such participant under any Award theretofore granted and any Award agreement relating thereto.

Executive Officers. Members of our management, including some of those who participated in the Merger Transactions as continuing investors, received awards under the Plan. On November 8, 2005 we awarded Rocco A. Ortenzio and Robert A. Ortenzio with restricted stock Awards in the amount of 1,125,000 and 1,575,000 shares of our common stock, respectively. The restricted stock Award granted to Rocco A. Ortenzio is not subject to vesting, and the restricted stock Award granted to Robert A. Ortenzio is subject to ratable monthly vesting over a three year period from the date of grant. See Management Compensation Discussion and Analysis Elements of Compensation Equity Compensation and Management Compensation Discussion and Analysis Equity Compensation Plan Information.

2005 Equity Incentive Plan for Non-Employee Directors

On August 10, 2005, our board of directors (the Board) adopted the Select Medical Holdings Corporation 2005 Equity Incentive Plan for Non-Employee Directors (the Plan). The Board and the stockholders approved an amendment and restatement of the Plan that will become effective immediately prior to the consummation of this offering. The purpose of the Plan is to assist us and our subsidiaries in attracting and retaining qualified individuals to serve as

non-employee members of the Board or the board of directors of our subsidiaries (each, a Subsidiary Board), and to align such individuals interests with those of our other stockholders, thereby promoting our long-term financial interests. The Plan accomplishes these goals through the grant of awards of restricted stock and options. The Plan, as it will be in effect following its amendment and restatement, is described below.

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Summary of the Plan

General. The Plan authorizes the grant of restricted stock and options (collectively, Awards). Options granted under the Plan are non-qualified stock options that are not intended to qualify as incentive stock options within the meaning of section 422 of the Internal Revenue Code of 1986, as amended (the Code).

Number of Shares Authorized. Subject to adjustment as described below, the maximum number of shares available for Awards under the Plan in respect of (i) restricted stock Awards is 150,000 shares, and (ii) options is 75,000 shares.

If any shares subject to an Award are forfeited or if such Award otherwise terminates or is settled for any reason whatsoever without an actual distribution of shares to the participant, any shares counted against the number of shares available for issuance pursuant to the Plan with respect to such Award will, to the extent of any such forfeiture, settlement, or termination, again be available for Awards under the Plan. In addition, if there is any change in Holdings corporate capitalization, such as a stock split, stock dividend, spinoff, recapitalization, merger, consolidation or the like, the committee selected by the Board to administer the Plan (the Committee) will equitably adjust the aggregate number and class of shares with respect to which Awards may be made under the Plan, as well as the terms, number and class of shares subject to outstanding Awards. The Committee may also make adjustments in the terms and conditions of Awards in recognition of unusual or nonrecurring events affecting Holdings or any of its subsidiaries or affiliates, or in response to changes in applicable laws, regulations, or accounting principles; provided, that no such adjustment may be made in any outstanding Awards to the extent that such adjustment would constitute a repricing of any option under the rules of any applicable national securities exchange.

Administration. The Plan is administered by the Committee. The Committee s powers include, but are not limited to, the power to:

select the non-employee directors who will receive Awards pursuant to the Plan;

determine the type or types of Awards to be granted to each participant;

determine the number of shares to which an Award will relate, the terms and conditions of any Award granted under the Plan and all other matters to be determined in connection with an Award;

determine whether, to what extent, and under what circumstances an Award may be canceled, forfeited, or surrendered;

determine whether, and to certify that, performance goals to which the settlement of an Award is subject are satisfied;

correct any defect, supply any omission or reconcile any inconsistency in the Plan;

adopt, amend and rescind such rules and regulations as, in its opinion, may be advisable in the administration of the Plan;

determine the effect, if any, of a change of control on outstanding Awards; and

construe and interpret the Plan and make all other determinations as it may deem necessary or advisable for the administration of the Plan.

Eligibility. Only non-employee members of the Board or a Subsidiary Board are eligible to participate in the Plan.

Each Award granted under the Plan will be evidenced by a written agreement between the holder and Holdings, which will describe the Award and state the terms and conditions applicable to such Award. The principal terms and conditions of the Awards that may be granted under the Plan are described below.

Restricted Stock

In a restricted stock Award, the Committee grants to a participant shares of stock that are subject to certain restrictions, including forfeiture of such stock upon the happening of certain events. Shares of stock are issued at the

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time of grant, but are held by Holdings and delivered to the grantee at the end of the restriction period specified in the Award agreement. During the restriction period, grantees of restricted stock have the right to vote the shares of such stock, and except as may otherwise be provided by the Committee, to receive dividends from such stock.

Options

Options granted under the Plan are non-qualified stock options that are not intended to qualify as incentive stock options within the meaning of section 422 of the Code. The Committee will determine, at the time of grant, the exercise price of the option, the term of the option, and the date when the option will become exercisable.

Exercise Price. The Committee will determine the exercise price of an option at the time the option is granted, provided that the exercise price of an option may not be less than 100% of the fair market value of the stock on the date of grant.

Consideration. The means of payment for shares issued upon exercise of an option will be established by the Committee and may be made by the holder (1) in cash, (2) by delivery of shares of stock having an aggregate fair market value equal to the aggregate exercise price, provided that such shares have been outstanding for at least six months (unless a shorter period is approved by the Committee), (3) by irrevocably authorizing a third party acceptable to the Committee to sell the shares of stock acquired upon exercise of the option and to remit a portion of such proceeds to Holdings sufficient to pay the exercise price of such option and to satisfy all applicable withholding taxes or (4) by any other means (including any combination of the foregoing) approved by the Committee.

Term of the Option. The term of an option granted under the Plan will expire upon the earlier of (1) the tenth anniversary of the date of grant, (2) the date established by the Committee at the time of grant, (3) unless otherwise provided by the Committee, the date that is one year after the holder s termination of service by reason of death or disability or (4) unless otherwise provided by the Committee, the date that is 90 days after the holder s termination of service other than by reason of death or disability (the Expiration Date).

General Provisions

Issuance of Shares with Respect to Awards. Holdings has no obligation to issue shares of stock under the Plan unless such issuance would comply with all applicable laws and the applicable requirements of any securities exchange or similar entity.

Nontransferability of Awards. In general, during a holder s lifetime, his or her Awards of restricted stock, to the extent such shares remain subject to forfeiture restrictions, and options are not transferable other than by will or by the laws of descent and distribution or, if permitted by the Committee in the applicable Award agreement, to the holder s immediate family members and certain entities controlled by or benefiting the holder or such family members (Permitted Transferees). Options are exercisable during the lifetime of the holder only by the holder or, in the case of a disabled holder, his or her guardian or legal representative. If permitted by the Committee, options may also be exercised by the holder s Permitted Transferee.

Termination of Service. All options will be forfeited upon a holder s termination of service with Holdings and its subsidiaries for cause, and unless the Committee provides otherwise, all unvested options will be forfeited upon a holder s termination of service with Holdings and its subsidiaries for any reason. Unless the Committee provides otherwise, upon a holder s termination of service with Holdings and its subsidiaries, vested options may be exercised until their Expiration Date. Except as may otherwise be provided by the Committee, all unvested shares of restricted stock will be forfeited upon a holder s termination of service with Holdings and its subsidiaries for any reason.

Change of Control

In the event of a change of control, the Committee may, in its discretion, (1) fully vest any or all Awards granted under the Plan, (2) cancel any outstanding option in exchange for a cash payment of an amount (including zero) equal to the difference, if any, between the then fair market value of the option less the exercise price of the option; provided that if the Committee determines that the exercise price exceeds the fair market value of the option,

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the Committee may cancel such option with no further payment due the participant, (3) after having given the participant a reasonable chance to exercise any outstanding options, terminate any or all of the participant s unexercised options, (4) where Holdings is not the surviving corporation, cause the surviving corporation to assume all outstanding Awards or replace all outstanding Awards with comparable awards, or (5) take such other action as the Committee determines to be appropriate.

As defined in the Plan, the term change of control generally means:

(i) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or a series of related transactions, of all or substantially all of the properties or assets of Holdings and its subsidiaries or Select Medical Corporation (Select) and its subsidiaries, in either case, taken as a whole, to any person (as that term is used in Section 13(d) of the Securities Exchange Act of 1934 (the 1934 Act) other than to certain individuals and entities who had significant ownership of Holdings prior to the offering, as well as certain affiliates and family members of such individuals and entities (Permitted Holders);

(ii) the consummation of any transaction (including, without limitation, any merger or consolidation), the result of which is that any person (as that term is used in Section 13(d) of the 1934 Act), other than Permitted Holders, becomes the beneficial owner, directly or indirectly, of more than 40% of the stock of Holdings or Select that is entitled to vote in the election of directors of such entity (Voting Stock), measured by voting power rather than number of shares, unless the Permitted Holders are the beneficial owners of a greater percentage of the Voting Stock of Holdings or Select, as the case may be; provided, however, that for purposes of this clause (ii), each person will be deemed to beneficially own any Voting Stock of another person held by one or more of its subsidiaries; or

(iii) the first day on which a majority of the members of the Board or the board of directors of Select (the Select Board) are not continuing directors. For purposes of the Plan, a continuing director means, as of any date of determination, any member of the Board or the Select Board who: (1) was a member of such board of directors on the first date Select became a wholly-owned subsidiary of Holdings; (2) was nominated for election or elected to such board of directors with the approval of a majority of the continuing directors who were members of such board of directors at the time of such nomination or election; or (3) was designated or appointed with the approval of Permitted Holders holding a majority of the Voting Stock of all of the Permitted Holders.

Effective Date, Amendments, and Termination of the Plan. The Plan became effective on August 5, 2005. The amendment and restatement of the Plan, which has been described above, was approved by the Board and the stockholders and will become effective immediately prior to the consummation of this offering. Unless earlier terminated by the Board, the Plan will terminate on August 12, 2019. The Board may amend the Plan without the consent of the stockholders or participants, except that any such amendment will be subject to the approval of Holdings stockholders if (1) such action would increase the number of shares of stock subject to the Plan, (2) such action would result in the repricing of any option or (3) such stockholder approval is required by any federal or state law or regulation or the rules of any stock exchange or automated quotation system on which Holdings stock is then listed or quoted. In addition, without the consent of an affected participant, no amendment or termination of the Plan may materially and adversely affect the rights of such participant under any Award theretofore granted and any Award agreement relating thereto.

Employee Stock Purchase Plan

In 2005, we adopted an employee stock purchase plan (the ESPP) whereby specified employees (other than members of our senior management team), directors and consultants of Holdings and its subsidiaries were given the opportunity, through a special offering (the ESPP Offering), to purchase shares of our common and preferred stock. Pursuant to the terms of the ESPP, 179,993 shares of Holdings common stock and 89,216 shares of Holdings preferred

stock were authorized to be issued in connection with the ESPP Offering. All shares authorized to be issued pursuant to the ESPP Offering have been issued and, pursuant to the terms of the ESPP, the ESPP Offering was terminated. In addition, it is anticipated that in connection with this offering, the restrictions applicable to all such shares will lapse.

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PRINCIPAL STOCKHOLDERS

The following table sets forth information regarding the beneficial ownership of our common stock as of the consummation of this offering by:

each person known to us to beneficially own more than 5% of the outstanding shares of common stock;

each of our named executive officers;

each of our directors; and

all of our directors and executive officers as a group.

The table also sets forth such persons beneficial ownership of our common stock immediately after the offering.

We have determined beneficial ownership in accordance with the rules of the SEC. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the persons and entities named in the tables below have sole voting and investment power with respect to all shares of common stock that they beneficially own, subject to applicable community property laws. We have based our calculation of the percentage of beneficial ownership on 61,815,899 shares of common stock outstanding on August 31, 2009 and 156,092,873 shares of common stock outstanding upon completion of this offering.

In computing the number of shares of common stock beneficially owned by a person or group and the percentage ownership of that person or group, we deemed to be outstanding any shares of common stock subject to options held by that person or group that are currently exercisable or exercisable within 60 days after August 31, 2009. We did not deem these shares outstanding, however, for the purpose of computing the percentage ownership of any other person.

Unless otherwise noted below, the address of each beneficial owner listed in the table is c/o Select Medical Holdings Corporation, 4714 Gettysburg Road, Mechanicsburg, Pennsylvania 17055 and our telephone number is (717) 972-1100.

Name of Beneficial Owner[1]	Number of Shares of Common Stock Beneficially Owned(2)	Percent of Common Stock Beneficially Owned	
		Before Offering	After Offering
Welsh, Carson, Anderson & Stowe[3]	84,114,467	66.7%	53.9%
Thoma Cressey Bravo[4]	12,842,122	10.2	8.2
Rocco A. Ortenzio[5]	10,326,168	8.2	6.6
Robert A. Ortenzio[6]	10,774,931	8.5	6.9
Russell L. Carson	2,129,061	1.7	1.4
Bryan C. Cressey[7]	13,140,433	10.4	8.4
David S. Chernow[8]	22,431	*	*
James E. Dalton, Jr.	44,377	*	*

James S. Ely III		*	*
Thomas A. Scully	52,023	*	*
Leopold Swergold	154,108	*	*
Sean M. Traynor	3,658	*	*
Patricia A. Rice[9]	2,279,403	1.8	1.5
S. Frank Fritsch	588,731	*	*
Martin F. Jackson[10]	1,272,194	1.0	*
All directors and executive officers as a group (18 persons)	41,965,260	33.3	26.9

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* Less than 1%

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(1) Unless otherwise indicated, the address of each of the beneficial owners identified is c/o Select Medical Holdings Corporation, 4714 Gettysburg Road, P.O. Box 2034, Mechanicsburg, Pennsylvania 17055.

(2) All shares of our issued and outstanding preferred stock will convert into shares of common stock at the time the offering is consummated. Therefore, no shares of participating preferred stock will be outstanding after the offering.

(3) Represents (i) 59,150,158 common shares held by Welsh, Carson, Anderson & Stowe IX, L.P., or WCAS IX, over which WCAS IX has sole voting and investment power, (ii) 10,973 common shares held by WCAS Management Corporation, over which WCAS Management Corporation has sole voting and investment power, (iii) 2,650,586 common shares held by WCAS Capital Partners IV, L.P., over which WCAS Capital Partners IV, L.P. has sole voting and investment power, (iv) an aggregate of 6,035,968 common shares held by individuals who are general partners of WCAS IX Associates LLC, the sole general partner of WCAS IX and/or otherwise employed by an affiliate of Welsh, Carson, Anderson & Stowe, and (v) an aggregate 16,266,782 common shares held by other co-investors, over which WCAS IX has sole voting power. Each of the following individuals are managing members of WCAS IX Associates, LLC, the sole general partner of WCAS IX, and WCAS CP IV Associates, LLC, the sole general partner of WCAS Capital Partners IV, L.P.: Patrick J. Welsh, Russell L. Carson, Bruce K. Anderson, Thomas E. Mclnerney, Robert A. Minicucci, Anthony J. de Nicola, Paul B. Queally, D. Scott Mackesy, Sanjay Swani, John D. Clark, Sean M. Traynor, John Almeida and Jonathan M. Rather. In addition, Thomas A. Scully is also a managing member of WCAS CP IV Associates, LLC. Each of the following individuals are shareholders of WCAS Management Corporation: Patrick J. Welsh, Russell L. Carson, Bruce K. Anderson, Jonathan M. Rather and Robert A. Minicucci. The principal executive offices of Welsh, Carson, Anderson & Stowe are located at 320 Park Avenue, Suite 2500, New York, New York 10022.

(4) Represents (i) 5,472,015 common shares held by Thoma Cressey Fund VI, L.P. over which Thoma Cressey Fund VI, L.P. has shared voting and investment power, (ii) 54,720 common shares held by Thoma Cressey Friends Fund VI, L.P., over which Thoma Cressey Friends Fund VI, L.P. has shared voting and investment power, (iii) 7,202,876 common shares held by Thoma Cressey Fund VII, L.P., over which Thoma Cressey Fund VII, L.P. has shared voting and investment power, and (iv) 112,511 common shares held by Thoma Cressey Friends Fund VII, L.P., over which Thoma Cressey Friends Fund VII, L.P. has shared voting and investment power. The sole general partner of each of Thoma Cressey Fund VII, L.P. and Thoma Cressey Friends Fund VII, L.P. , or collectively, Thoma Cressey Fund VII, is TC Partners VII, L.P., or the Fund VII GP. The sole general partner of Fund VII GP is Thoma Cressey Equity Partners Inc., or the Ultimate GP. The sole general partner of each of Thoma Cressey Fund VI, L.P. and Thoma Cressey Friends Fund VI, L.P., or collectively, Thoma Cressey Fund VI, is TC Partners VI, L.P., or the Fund VI GP. The sole general partner of Fund VI GP is the Ultimate GP. The sole shareholder of the Ultimate GP is Carl D. Thoma. The officers of the Ultimate GP are Carl D. Thoma, Bryan C. Cressey and Lee M. Mitchell. The principal executive offices of the Ultimate GP are located at 233 South Wacker, Chicago, IL 60606.

(5) Includes 6,485,266 common shares owned by the Rocco A. Ortenzio Revocable Trust for which Mr. Rocco Ortenzio acts as sole trustee, and 3,750,000 common shares held by the Rocco A. Ortenzio Descendants Trust, for which Mr. Rocco Ortenzio is the investment advisor. Mr. Rocco Ortenzio disclaims beneficial ownership of shares held by the Rocco A. Ortenzio Descendants Trust except in his capacity as a fiduciary of such trust.

(6) Includes 2,100,000 common shares owned by the Robert A. Ortenzio Descendants Trust for which Mr. Robert Ortenzio is the investment trustee. Mr. Robert Ortenzio disclaims beneficial ownership of shares held by the Robert A. Ortenzio Descendant s Trust except in his capacity as a fiduciary of such trust.

(7) In addition to shares owned by Bryan C. Cressey in his individual capacity, includes (i) 5,472,015 common shares held by Thoma Cressey Fund VI, L.P., (ii) 54,720 common shares held by Thoma Cressey Friends Fund VI, L.P., (iii) 7,202,876 common shares held by Thoma Cressey Fund VII, L.P., and (iv) 112,511 common shares held by Thoma Cressey Friends Fund VII, L.P. Mr. Cressey is a principal of Thoma Cressey Equity Partners Inc. Mr. Cressey may be deemed to beneficially own the shares beneficially owned by Thoma Cressey Fund VI, L.P., Thoma Cressey Friends Fund VI, L.P., Thoma Cressey Fund VII, L.P. and Thoma Cressey Friends Fund VII, L.P. Mr. Cressey disclaims beneficial ownership of such shares. The principal

address of Mr. Cressey is 9200 Sears Tower, 233 South Wacker Drive, Chicago, IL 60606.

(8) Includes 14,631 common shares held by David S. Chernow and Elizabeth A. Chernow as tenants in common.

(9) Includes 1,048,061 common shares owned by The Patricia Ann Rice Living Trust for which Ms. Rice acts as a trustee, and 784,500 common shares owned by the 2005 Rice Family Trust for which Ms. Rice acts as investment trustee.

(10) Includes an aggregate 10,534 common shares owned by Mr. Jackson s children who live in his household and over which Mr. Jackson acts as custodian.

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CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Arrangements with Our Investors

In connection with the consummation of the Merger Transactions, Welsh Carson, Thoma Cressey and their co-investors and individuals affiliated with Welsh Carson, each of whom beneficially own more than 5% of the outstanding shares of our common stock, and our continuing investors, including Rocco A. Ortenzio, Robert A. Ortenzio, Russell L. Carson, Bryan C. Cressey, Patricia A. Rice, Martin F. Jackson, S. Frank Fritsch, Michael E. Tarvin, James J. Talalai and Scott A. Romberger, each of whom are either executive officers or directors of our company, entered into agreements with us as described below.

Stock Subscription and Exchange Agreement

Pursuant to a stock subscription and exchange agreement, in connection with the Merger Transactions the investors purchased shares of our preferred stock and common stock for an aggregate purchase price of $570.0 million in cash plus rollover shares of Select common stock (with such rollover shares being valued at $152.0 million in the aggregate, or $18.00 per share, for such purposes). Our continuing investors purchased shares of our stock at the same price and on the same terms as our sponsors and their co-investors. Upon consummation of the Merger, all rollover shares were cancelled without payment of any merger consideration.

In July 2005, Mr. Chernow purchased 2,973.98 shares of our preferred stock and 6,000 shares of our common stock for an aggregate of $100,000; Mr. Dalton purchased 7,434.94 shares of our preferred stock and 15,000 shares of our common stock for an aggregate of $250,000; and Mr. Swergold purchased 29,739.78 shares of our preferred stock and 60,000 shares of our common stock for an aggregate of $1.0 million.

On September 29, 2005, we incurred $14.5 million of expense in connection with a payment of $14.2 million to certain members of management under the Cash Plan as a result of a special dividend paid to holders of our preferred stock with the proceeds of the $175.0 million senior floating rate notes issued by us. The balance of the $14.5 million expense resulted from the employer s portion of the payroll taxes associated with the payment to management.

Stockholders Agreement and Equity Registration Rights Agreement

The stockholders agreement entered into by our investors in connection with the Merger Transactions contains certain restrictions on the transfer of our equity securities and provides certain stockholders with certain preemptive and information rights. Pursuant to the registration rights agreement, we granted certain of our investors rights to require us to register shares of common stock under the Securities Act.

Securities Purchase Agreement and Debt Registration Rights Agreement

In connection with the Merger Transactions, Holdings, WCAS Capital Partners IV, L.P., Rocco A. Ortenzio, Robert A. Ortenzio and certain other investors who are members of or affiliated with the Ortenzio family entered into a securities purchase agreement pursuant to which they purchased senior subordinated notes and shares of preferred and common stock from us for an aggregate $150.0 million purchase price. In connection with such investment, these investors entered into the stockholders and registration rights agreements referred to under Stockholders Agreement and Equity Registration Rights Agreement with respect to our equity securities acquired by them and a separate registration rights agreement with us that granted these investors rights to require us to register the senior subordinated notes acquired by them under the Securities Act under certain circumstances.

Transaction Fee

In connection with the Merger Transactions, an aggregate $24.6 million in financing fees was paid to our sponsors (or affiliates thereof) and to certain of our other continuing investors in connection with the Merger Transactions and we reimbursed Welsh Carson and its affiliates for their out-of-pocket expenses in connection with the Merger Transactions.

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Restricted Stock Award Agreement

On June 2, 2005, Rocco A. Ortenzio and Holdings entered into a Restricted Stock Award Agreement, pursuant to which a warrant previously granted to Mr. Ortenzio was cancelled and Mr. Ortenzio was awarded shares of our common stock.

Holdings 10% Senior Subordinated Notes

Concurrently with the consummation of the Merger Transactions, we issued to WCAS Capital Partners IV, L.P., an investment fund affiliated with Welsh Carson, Rocco A. Ortenzio and Robert A. Ortenzio, $141.0 million, $3.0 million and $1.0 million, respectively, in principal amount of our 10% senior subordinated notes. In the year ended December 31, 2008, we made interest payments to WCAS Capital Partners IV, L.P., Rocco A. Ortenzio and Robert A. Ortenzio in the amount of $14,100,000, $300,000 and $100,000, respectively.

Other Arrangements with Directors and Executive Officers

Lease of Office Space

We lease our corporate office space at 4714, 4716, 4718 and 4720 Gettysburg Road in Mechanicsburg, Pennsylvania, from Old Gettysburg Associates, Old Gettysburg Associates II, Old Gettysburg Associates III and Old Gettysburg Associates IV. Old Gettysburg Associates is a general partnership that is owned by Rocco A. Ortenzio, Robert A. Ortenzio and John M. Ortenzio. Old Gettysburg Associates II, Old Gettysburg Associates III and Old Gettysburg Associates IV are limited partnerships each owned by Rocco A. Ortenzio, Robert A. Ortenzio and John M. Ortenzio, as limited partners, and Select Capital Commercial Properties, Inc., as the general partner. Select Capital Commercial Properties, Inc. is a Pennsylvania corporation whose principal offices are located in Mechanicsburg, Pennsylvania. Rocco A. Ortenzio, Robert A. Ortenzio and John M. Ortenzio each own one-third of Select Capital Commercial Properties, Inc. We obtained independent appraisals at the time we executed leases with these partnerships which support the amount of rent we pay for this space. In the year ended December 31, 2008, we paid to these partnerships an aggregate amount of $3.3 million, for office rent, for various improvements to our office space and miscellaneous expenses in connection with our leases of corporate office space then in effect at 4716, 4718 and 4720 Gettysburg Road. Our current lease for 43,919 square feet of office space at 4716 Gettysburg Road will expire on January 31, 2023. Our lease for 6,895 square feet of office space at 4718 Gettysburg Road will expire on December 31, 2014. Our lease for 4,635 square feet of office space at 4718 Gettysburg Road will expire on January 31, 2023.

On May 15, 2001, we entered into a lease for 7,214 square feet of additional office space at 4720 Gettysburg Road in Mechanicsburg, Pennsylvania which expires on December 31, 2014. We amended this lease on February 26, 2002 to add a net of 4,200 square feet of office space. We amended this lease on October 1, 2008 to relinquish a net of 2,631 square feet of office space. Effective on May 1, 2009, we amended this lease to relinquish a net of 3,206 square feet. Therefore, the lease now covers 5,577 square feet. On October 29, 2003, we entered into a lease for an additional 3,008 square feet of office space at 4718 Gettysburg Road for a five year initial term at $17.40 per square foot. We amended this lease on November 1, 2008 to extend the term of the lease on a month to month basis at a rate of $20.67 per rentable square foot. Effective on May 1, 2009, we amended this lease to extend the term to December 31, 2014 and provide for an initial rental rate of $20.00 per square foot. On October 29, 2003, we entered into a lease for an additional 8,644 square feet of office space at 4720 Gettysburg Road for a five year initial term at $18.01 per square foot. We amended this lease on October 1, 2008 to extend the term of the lease on a month to month basis at a rate of $21.13 per rentable square foot. Effective on May 1, 2009, we amended this lease to extend the term to December 31, 2014 and provide for an initial rental rate of $21.00 per square foot. On October 5, 2006, we entered into a lease for 1,606 square feet of additional space at 4718 Gettysburg Road at $18.64 per square foot. Such lease will expire on February 28, 2012.

We currently pay approximately $3.2 million per year in rent for the office space leased from these four partnerships in connection with our current leases of corporate office space at 4714, 4716, 4718 and 4720 Gettysburg Road. Each of Rocco A. Ortenzio, Robert A. Ortenzio and John M. Ortenzio have a 33.33% interest in payments made to each of Old Gettysburg Associates, Old Gettysburg Associates II, Old Gettysburg Associates III and Old Gettysburg Associates IV, based on his direct and indirect ownership in these partnerships. This amount includes lease payments for the office space at 4714 Gettysburg Road which commenced on February 15, 2008. We

amended our lease for office space at 4718 Gettysburg Road on February 19, 2004 to relinquish a net of 695 square feet of office space. On March 19, 2004, we entered into leases for an additional 2,436 square feet of office space at 4718 Gettysburg Road from Old Gettysburg Associates for a three year initial term at $19.31 per square foot, and an additional 2,579 square feet of office space at 4720 Gettysburg Road from Old Gettysburg Associates II for a five year initial term at $18.85 per square foot. Effective on April 1, 2009, we amended the lease covering the 2,579 square feet of space at 4720 Gettysburg Road to extend the term on a month to month basis, and effective May 1, 2009, we amended such lease to extend the term to December 31, 2014 and provide for an initial rental rate of $21.00 per square foot. On February 28, 2007, we renewed a lease at 4718 Gettysburg Road for an additional three year term at $21.10 per square foot for 2,562 square feet.

On August 10, 2005, we entered into a lease for approximately 8,615 square feet of additional office space at 4720 Gettysburg Road in Mechanicsburg, Pennsylvania with Old Gettysburg Associates II. Such lease will expire on July 31, 2010. Effective on May 1, 2009, we amended this lease to relinquish a net of 1,204 square feet. Therefore, the lease now covers 7,411 square feet. On August 25, 2006, we entered into a lease for 47,864 square feet of office space at 4714 Gettysburg Road in Mechanicsburg, Pennsylvania for a 15 year term at $23.53 per square foot, subject to an annual base rent increase of 4% on a cumulative basis, plus expense allocations. Such lease commenced on February 15, 2008 and will expire on January 31, 2023.

Senior Secured Credit Facility

Prior to joining our board of directors on November 13, 2008, Mr. Ely was a Managing Director of J.P. Morgan Securities Inc. JPMorgan Chase Bank, N.A., an affiliate of J.P. Morgan Securities Inc., is the administrative agent, the collateral agent and a lender under our senior secured credit facility. Our senior secured credit facility provides for senior secured financing consisting of:

- a $300.0 million revolving loan facility that will terminate on February 24, 2011, including both a letter of credit sub-facility and a swingline loan sub-facility,
- $268.6 million in Tranche B term loans that mature on February 24, 2012, and
- $384.5 million in Tranche B-1 term loans that mature on August 22, 2014.

The largest aggregate amount of principal outstanding under our senior secured credit facility since the beginning of 2008 was $868.7 million. The amount of principal under our senior secured credit facility as of June 30, 2009 was $768.1 million. Since the beginning of 2008, Select has paid $10.2 million in term loan principal under our senior secured credit facility.

The amount of interest paid by Select under our senior secured credit facility since the beginning of 2008 is $75.3 million. The interest rates per annum applicable to loans, other than swingline loans and Tranche B-1 term loans, under our senior secured credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The interest rates per annum applicable to Tranche B-1 term loans under our senior credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The alternate base rate is the greater of (1) JPMorgan Chase Bank, N.A. s prime rate and (2) one-half of 1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate is determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The

applicable margin percentage for borrowings under our revolving loans is subject to change based upon the ratio of Select s total indebtedness to consolidated EBITDA (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 1.50% for alternate base rate loans and (2) 2.50% for adjusted LIBOR loans. The applicable margin percentages for Tranche B term loans are (1) 1.00% for alternate base rate loans and (2) 2.00% for adjusted LIBOR loans. The applicable margin percentages for Tranche B-1 term loans are (1) 2.75% for alternate base rate loans and (2) 3.75% for adjusted LIBOR loans. Swingline loans will bear interest at the interest rate applicable to alternate base rate revolving loans.

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If, prior to August 5, 2011, our senior secured credit facility is amended to reduce the applicable rate for Tranche B-1 term loans, then we will be required to pay a fee in an amount equal to 1% of the outstanding Tranche B-1 term loans held by those holders of Tranche B-1 term loans that agree to amend our senior secured credit facility to reduce the applicable rate. In addition, if, prior to August 5, 2011, we make any prepayment of Tranche B-1 term loans with proceeds of any term loan indebtedness, then we will be required to pay a fee to holders of Tranche B-1 term loans in an amount equal to 1% of the outstanding Tranche B-1 term loans that are being prepaid. Our senior secured credit facility was negotiated on an arms length basis and contains customary terms pursuant to which the lenders receive customary fees. See Description of Indebtedness Senior Secured Credit Facility.

Approval of Related Party Transactions

We do not have a formal written policy for review and approval of transactions required to be disclosed pursuant to Item 404(a) of Regulation S-K. However, our practice is that any such transaction must receive the prior approval of both the audit committee and a majority of the non-interested members of the board of directors. In addition, it is our practice that, prior to any related party transaction of the type described under Other Arrangements with Directors and Executive Officers Lease of Office Space, an independent third-party appraisal is obtained that supports the amount of rent that we are obligated to pay for such leased space. All related party lease transactions have been unanimously approved by all of the non-interested members of the board of directors.

DESCRIPTION OF CAPITAL STOCK

The following descriptions are summaries of the material terms of our restated certificate of incorporation and amended and restated by-laws as will be in effect immediately prior to the closing of this offering and relevant sections of the Delaware General Corporate Law, or the DGCL. Reference is made to the more detailed provisions of, and the descriptions are qualified in their entirety by reference to, our restated certificate of incorporation and amended and restated by-laws, copies of which are filed with the SEC as exhibits to the registration statement of which this prospectus is a part, and applicable law.

General

Our authorized capital stock as set forth in our Restated Certificate of Incorporation consists of 700,000,000 shares of common stock, par value $0.001 per share and 70,000,000 shares of preferred stock, par value of $0.001 per share. As of August 31, 2009, there were 61,815,899 shares of common stock issued and outstanding.

All of our existing stock is, and the shares of common stock being offered by us in this offering will be, upon payment therefore, validly issued, fully paid and nonassessable. This discussion set forth below describes the material terms of our capital stock, certificate of incorporation and bylaws that will be in effect upon completion of this offering.

Common Stock

The holders of our common stock are entitled to dividends as our board of directors may declare from funds legally available therefore, subject to the preferential rights of the holders of our preferred stock, if any, and any contractual limitations on our ability to declare and pay dividends. The holders of our common stock are entitled to one vote per share on any matter to be voted upon by stockholders. Our certificate of incorporation does not provide for cumulative voting in connection with the election of directors, and accordingly, holders of more than 50% of the shares voting will be able to elect all of the directors. No holder of our common stock will have any preemptive right to subscribe for any shares of capital stock issued in the future.

Upon any voluntary or involuntary liquidation, dissolution, or winding up of our affairs, the holders of our common stock are entitled to share ratably in all assets remaining after payment of creditors and subject to prior distribution rights of our preferred stock, if any. All of the outstanding shares of common stock are, and the shares offered by us will be, fully paid and non-assessable.

Preferred Stock

As of the closing of this offering, no shares of our preferred stock will be outstanding. Our certificate of incorporation provides that our board of directors may by resolution establish one or more classes or series of preferred stock having the number of shares and relative voting rights, designation, dividend rates, liquidation, and other rights, preferences, and limitations as may be fixed by them without further stockholder approval. The holders of our preferred stock may be entitled to preferences over common stockholders with respect to dividends, liquidation, dissolution, or our winding up in such amounts as are established by our board of directors resolutions issuing such shares.

The issuance of our preferred stock may have the effect of delaying, deferring or preventing a change in control of us without further action by the holders and may adversely affect voting and other rights of holders of our common stock. In addition, issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could make it more difficult for a third party to acquire a majority of the

outstanding shares of voting stock. At present, we have no plans to issue any shares of preferred stock.

Registration Rights

Welsh Carson, Thoma Cressey, Rocco A. Ortenzio, Robert A. Ortenzio and certain other stockholders, including individuals affiliated with Welsh Carson, possess registration rights with respect to our common stock.

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These stockholders who are currently the holders of 78,980,732 shares of our common stock after the completion of this offering have the right to demand that we register the resale of their shares under the Securities Act. We are not obligated to register any shares held by these stockholders upon their request for 180 days from the date of this prospectus. Subject to the terms of lock-up agreements between these stockholders and the underwriters, however, if we file a registration statement to register sales of our common stock (other than under our employee benefit plans) during that time, these stockholders will be entitled to register any portion or all of their shares to be included in that offering. After the expiration of this 180 day period, these stockholders may demand that we register any portion or all of their shares at any time. At any time, if we propose to register any of our securities under the Securities Act, these stockholders are entitled to notice of the registration and, subject to customary conditions and limitations, are entitled to include their shares in our registration. These stockholders may demand that we effect a registration on Form S-1 or any similar long form registration, or Form S-3 or any similar short form registration, if we are able to register securities on those forms at that time, in which we shall pay all registration expenses. We are required to use our best efforts to effect these registrations, subject to customary conditions and limitations. Welsh Carson, on behalf of itself and all other investors that possess such rights, has waived any and all registration rights and notice requirements in connection with this prospectus.

Anti-Takeover Effects of Our Certificate of Incorporation and Bylaws and Delaware Law

The following is a description of certain provisions of the DGCL, and our certificate of incorporation and bylaws. This summary does not purport to be complete and is qualified in its entirety by reference to the DGCL, and our certificate of incorporation and bylaws.

Section 203 of the Delaware General Corporation Law

We are subject to the provisions of Section 203 of the DGCL. Section 203 of the DGCL prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved by our board of directors or our stockholders in a prescribed manner, or unless the interested stockholder owns at least 85% of our voting stock (excluding for this purpose shares held by our directors and officers). A business combination includes certain mergers, asset sales, and other transactions resulting in a financial benefit to the interested stockholder. Subject to certain exceptions, an interested stockholder is a person who, together with affiliates and associates, owns 15% or more of our voting stock, or who is an affiliate or an associate of us who, within the three years prior to the date the determination is to be made, did own 15% or more of our voting stock.

Certificate of Incorporation and Bylaws

Certain provisions of our certificate of incorporation and bylaws could have anti-takeover effects. These provisions are intended to enhance the likelihood of continuity and stability in the composition of our corporate policies formulated by our board of directors. In addition, these provisions also are intended to ensure that our board of directors will have sufficient time to act in what our board of directors believes to be in the best interests of us and our stockholders. These provisions also are designed to reduce our vulnerability to an unsolicited proposal for our takeover that does not contemplate the acquisition of all of our outstanding shares or an unsolicited proposal for the restructuring or sale of all or part of us. The provisions are also intended to discourage certain tactics that may be used in proxy fights.

However, these provisions could delay or frustrate the removal of incumbent directors or the assumption of control of us by the holder of a large block of common stock, and could also discourage or make more difficult a merger, tender offer, or proxy contest, even if such event would be favorable to the interest of our stockholders.

Classified Board of Directors. Our certificate of incorporation provides for our board of directors to be divided into three classes of directors, with each class as nearly equal in number as possible, serving staggered three year terms (other than directors which may be elected by holders of preferred stock, if any). As a result, approximately one-third of our board of directors will be elected each year. The classified board provision will

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help to assure the continuity and stability of our board of directors and our business strategies and policies as determined by our board of directors. The classified board provision could have the effect of discouraging a third party from making an unsolicited tender offer or otherwise attempting to obtain control of us without the approval of our board of directors. In addition, the classified board provision could delay stockholders who do not like the policies of our board of directors from electing a majority of our board of directors for two years.

No Stockholder Action by Written Consent; Special Meetings. Our certificate of incorporation provides that stockholder action can only be taken at an annual or special meeting of stockholders and prohibits stockholder action by written consent in lieu of a meeting. Our bylaws provide that special meetings of stockholders may be called only by our board of directors or our Chief Executive Officer. Our stockholders are not permitted to call a special meeting of stockholders or to require that our board of directors call a special meeting.

Advance Notice Requirements for Stockholder Proposals and Director Nominees. Our bylaws establish an advance notice procedure for our stockholders to make nominations of candidates for election as directors or to bring other business before an annual meeting of our stockholders. The stockholder notice procedure provides that only persons who are nominated by, or at the direction of, our board of directors or its Chairman, or by a stockholder who has given timely written notice to our Secretary or any Assistant Secretary prior to the meeting at which directors are to be elected, will be eligible for election as our directors. The stockholder notice procedure also provides that at an annual meeting, only such business may be conducted as has been brought before the meeting by, or at the direction of, our board of directors or its Chairman or by a stockholder who has given timely written notice to our Secretary of such stockholder s intention to bring such business before such meeting. Under the stockholder notice procedure, if a stockholder desires to submit a proposal or nominate persons for election as directors at an annual meeting, the stockholder must submit written notice to us not less than 90 days nor more than 120 days prior to the first anniversary of the previous year s annual meeting. In addition, under the stockholder notice procedure, a stockholder s notice to us proposing to nominate a person for election as a director or relating to the conduct of business other than the nomination of directors must contain certain specified information. If the chairman of a meeting determines that business was not properly brought before the meeting in accordance with the stockholder notice procedure, such business shall not be discussed or transacted.

Number of Directors; Removal; Filling Vacancies. Our bylaws provide that our board of directors will consist of not less than five or more than eleven directors, the exact number to be fixed from time to time by resolution adopted by our directors. Further, subject to the rights of the holders of any series of our preferred stock, if any, our bylaws authorize our board of directors to fill any vacancies that occur in our board of directors by reason of death, resignation, removal, or otherwise. A director so elected by our board of directors to fill a vacancy or a newly created directorship holds office until the next election of the class for which such director has been chosen and until his successor is elected and qualified. Subject to the rights of the holders of any series of our preferred stock, if any, our bylaws also provide that directors may be removed only for cause and only by the affirmative vote of holders of a majority of the combined voting power of our then outstanding stock. The effect of these provisions is to preclude a stockholder from removing incumbent directors without cause and simultaneously gaining control of our board of directors by filling the vacancies created by such removal with its own nominees.

Indemnification. We have included in our certificate of incorporation and bylaws provisions to (1) eliminate the personal liability of our directors for monetary damages resulting from breaches of their fiduciary duty to the extent permitted by the DGCL and (2) indemnify our directors and officers to the fullest extent permitted by Section 145 of the DGCL. We believe that these provisions are necessary to attract and retain qualified persons as directors and officers.

Amendments to Certificate of Incorporation. The provisions of our certificate of incorporation that could have anti-takeover effects as described above are subject to amendment, alteration, repeal, or rescission either by (1) our

board of directors without the assent or vote of our stockholders or (2) the affirmative vote of the holder of not less than two-thirds (662/3%) of the outstanding shares of voting securities, depending on the subject provision. This requirement makes it more difficult for stockholders to make changes to the provisions in our certificate of incorporation which could have anti-takeover effects by allowing the holders of a minority of the voting securities to prevent the holders of a majority of voting securities from amending these provisions of our certificate of incorporation.

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Amendments to Bylaws. Our certificate of incorporation provides that our bylaws are subject to adoption, amendment, alteration, repeal, or rescission either by (1) our board of directors without the assent or vote of our stockholders or (2) the affirmative vote of the holders of not less than two-thirds (662/3%) of the outstanding shares of voting securities. This provision makes it more difficult for stockholders to make changes in our bylaws by allowing the holders of a minority of the voting securities to prevent the holders of a majority of voting securities from amending our bylaws.

New York Stock Exchange Trading

We have applied to have our common stock approved for quotation on the New York Stock Exchange under the symbol SEM.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is BNY Mellon Shareowner Services.

DESCRIPTION OF INDEBTEDNESS

We summarize below the principal terms of the agreements that govern our senior secured credit facility, Select s 75/8% senior subordinated notes, our 10% senior subordinated notes and our senior floating notes. This summary is not a complete description of all the terms of such agreements.

Senior Secured Credit Facility

General

On February 24, 2005, we entered into our senior secured credit facility with a syndicate of financial institutions and institutional lenders. Set forth below is a summary of the terms of our senior secured credit facility, as amended to date.

On March 19, 2007, we entered into Amendment No. 2, and on March 28, 2007, we entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 increased the general exception to the prohibition on asset sales under our senior secured credit facility from $100.0 million to $200.0 million, relaxed certain financial covenants starting March 31, 2007 and waived Select s requirement to prepay certain term loan borrowings following the year ended December 31, 2006. The Incremental Facility Amendment provided to our company an incremental term loan of $100.0 million, the proceeds of which we used to pay a portion of the purchase price for the HealthSouth transaction.

On August 5, 2009, we entered into Amendment No. 3 to our senior secured credit facility with a group of holders of Tranche B term loans and JPMorgan Chase Bank, N.A., as administrative agent. Amendment No. 3 extended the maturity of $384.5 million principal amount of Tranche B term loans from February 24, 2012 to August 22, 2014. Holders of Tranche B term loans that extended the maturity of their Tranche B term loans now hold Tranche B-1 term loans that mature on August 22, 2014, and holders of Tranche B term loans that did not extend the maturity of their Tranche B term loans continue to hold Tranche B term loans that mature on February 24, 2012. The applicable rate for the Tranche B-1 term loans under our senior secured credit facility has increased to 3.75% for adjusted LIBOR loans and 2.75% for alternate base rate loans.

After giving effect to the Incremental Facility Amendment and Amendment No. 3, our senior secured credit facility provides for senior secured financing consisting of:

a $300.0 million revolving loan facility that will terminate on February 24, 2011, including both a letter of credit sub-facility and a swingline loan sub-facility,

$268.6 million in Tranche B term loans that mature on February 24, 2012, and

$384.5 million in Tranche B-1 term loans that mature on August 22, 2014.

In addition, we may request additional tranches of term loans or increases to the revolving credit facility in an aggregate amount not exceeding $100.0 million, subject to certain conditions, receipt of commitments by existing or additional financial institutions or institutional lenders and restrictions in the indentures governing Select s 75/8% notes and our senior floating rate notes.

All borrowings under our senior secured credit facility are subject to the satisfaction of required conditions, including the absence of a default at the time of and after giving effect to such borrowing and the accuracy of the representations and warranties of the borrowers.

Interest and Fees

The interest rates per annum applicable to loans, other than swingline loans and Tranche B-1 term loans, under our senior secured credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The interest rates per annum applicable to Tranche B-1 term loans under our senior credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The alternate base rate is the greater of (1) JPMorgan Chase Bank, N.A. s prime rate and (2) one-half of

1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate is determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject.

The applicable margin percentage for borrowings under our revolving loans is subject to change based upon the ratio of Select s total indebtedness to consolidated EBITDA (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 1.50% for alternate base rate loans and (2) 2.50% for adjusted LIBOR loans. The applicable margin percentages for Tranche B term loans are (1) 1.00% for alternate base rate loans and (2) 2.00% for adjusted LIBOR loans. The applicable margin percentages for Tranche B-1 term loans are (1) 2.75% for alternate base rate loans and (2) 3.75% for adjusted LIBOR loans. If, prior to August 5, 2011, our senior secured credit facility is amended to reduce the applicable rate for Tranche B-1 term loans, then we will be required to pay a fee in an amount equal to 1% of the outstanding Tranche B-1 term loans held by those holders of Tranche B-1 term loans that agree to amend our senior secured credit facility to reduce the applicable rate. Swingline loans will bear interest at the interest rate applicable to alternate base rate revolving loans.

On the last day of each calendar quarter we are required to pay each lender a commitment fee in respect of any unused commitments under the revolving credit facility, which is currently 0.50% per annum subject to adjustment based upon the ratio of Select s total indebtedness to its consolidated EBITDA.

Prepayments

Subject to exceptions, our senior secured credit facility requires mandatory prepayments of term loans in amounts equal to:

- 50% (as may be reduced based on Select s ratio of total indebtedness to its consolidated EBITDA) of Select s annual excess cash flow (as defined in the credit agreement);

- 100% of the net cash proceeds from asset sales and casualty and condemnation events, subject to reinvestment rights and certain other exceptions;

- 50% (as may be reduced based on Select s ratio of total indebtedness to its consolidated EBITDA) of the net cash proceeds from specified issuances of equity securities; and

- 100% of the net cash proceeds from certain incurrences of debt.

We may apply future voluntary prepayments entirely to the Tranche B term loans or pro rata between the Tranche B term loans and the Tranche B-1 term loans. If, prior to August 5, 2011, we make any prepayment of Tranche B-1 term loans with proceeds of any term loan indebtedness, then we will be required to pay a fee to holders of Tranche B-1 term loans in an amount equal to 1% of the outstanding Tranche B-1 term loans that are being prepaid. Voluntary prepayments and commitment reductions are otherwise permitted, in whole or in part, in minimum amounts without premium or penalty, other than breakage costs with respect to adjusted LIBOR rate loans in an amount equal to the difference between the amount of interest that would have accrued on such principal amount through the last day of the applicable interest period had the prepayment or commitment reduction not occurred over the amount of interest that would accrue on such principal amount for such period at the interest rate the lender would bid, were the lender to bid, at the beginning of such period for dollar deposits of a comparable amount from other banks in the eurodollar market.

This initial public offering triggers the mandatory prepayment obligation under our senior secured credit facility in the amount of 50% of the net proceeds we will receive in this offering. Our use of proceeds to pay off a portion of the outstanding term loans under our senior secured credit facility will satisfy this obligation.

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Amortization of Principal

On August 5, 2009, we entered into Amendment No. 3 to our senior secured credit facility, which extended the maturity of $384.5 million principal amount of the existing term loans into new Tranche B-1 term loans to August 22, 2014. The Tranche B-1 term loans have quarterly repayment requirements of $1.0 million until maturity, at which time the remaining balance of $365.3 million is due. The $268.6 million remaining balance of the Tranche B term loans continue to mature on February 24, 2012, and now have quarterly repayment requirements of $0.7 million through 2010, with the remaining balance due in four equal quarterly installments of $66.1 million, the final installment due at maturity.

Collateral and Guarantors

Our senior secured credit facility is guaranteed by us and substantially all of our current subsidiaries, and will be guaranteed by substantially all of our future subsidiaries and secured by substantially all of our existing and future property and assets and by a pledge of its capital stock and the capital stock of its subsidiaries.

Restrictive Covenants and Other Matters

Our senior secured credit facility requires that Select comply on a quarterly basis with certain financial covenants, including a minimum interest coverage ratio test and a maximum leverage ratio test, which financial covenants become more restrictive over time. For the four consecutive fiscal quarters ended June 30, 2009, Select was required to maintain an interest expense coverage ratio (its ratio of consolidated EBITDA to cash interest expense) for the prior four consecutive quarters of at least 1.75 to 1.00. As of June 30, 2009, Select was required to maintain its leverage ratio (its ratio of total indebtedness to consolidated EBITDA for the prior four consecutive fiscal quarters) at less than 5.25 to 1.00. On a pro forma as adjusted basis giving effect to this offering and the use of proceeds therefrom, for the four quarters ended June 30, 2009, Select s interest expense coverage ratio was 2.42 to 1.00 and Select s leverage ratio was 3.68 to 1.00 based upon the initial public offering price of $10.00 per share. Select s actual interest expense coverage ratio was 2.25 to 1.00 for the four quarters ended June 30, 2009, and Select s actual leverage ratio was 4.56 to 1.00 as of June 30, 2009.

In addition, our senior secured credit facility includes negative covenants, subject to significant exceptions, restricting or limiting our ability and the ability of Select and its restricted subsidiaries, to, among other things:

- incur, assume, permit to exist or guarantee additional debt and issue or sell or permit any subsidiary to issue or sell preferred stock;
- amend, modify or waiver any rights under the certificate of indebtedness, credit agreements, certificate of incorporation, bylaws or other organizational documents which would be materially adverse to the creditors;
- pay dividends or other distributions on, redeem, repurchase, retire or cancel capital stock;
- purchase or acquire any debt or equity securities of, make any loans or advances to, guarantee any obligation of, or make any other investment in, any other company;
- incur or permit to exist certain liens on property or assets owned or accrued or assign or sell any income or revenues with respect to such property or assets;
- sell or otherwise transfer property or assets to, purchase or otherwise receive property or assets from, or otherwise enter into transactions with affiliates;

merge, consolidate or amalgamate with another company or permit any subsidiary to merge, consolidate or amalgamate with another company;

sell, transfer, lease or otherwise dispose of assets, including any equity interests;

repay, redeem, repurchase, retire or cancel any subordinated debt;

incur capital expenditures;

engage to any material extent in any business other than business of the type currently conducted by Select or reasonably related businesses; and

incur obligations that restrict the ability of its subsidiaries to incur or permit to exist any liens on its property or assets or to make dividends or other payments to us.

Our senior secured credit facility also contains certain representations and warranties, affirmative covenants and events of default. The events of default include payment defaults, breaches of representations and warranties, covenant defaults, cross-defaults to certain indebtedness, certain events of bankruptcy, certain events under ERISA, material judgments, actual or asserted failure of any guaranty or security document supporting our senior secured credit facility to be in full force and effect and any change of control. If such an event of default occurs, the lenders under our senior secured credit facility will be entitled to take various actions, including the acceleration of amounts due under our senior secured credit facility and all actions permitted to be taken by a secured creditor.

Select s 75/8% Senior Subordinated Notes

On February 24, 2005, Select issued $660.0 million of senior subordinated notes due 2015. Select s 75/8% senior subordinated notes bear interest at a stated rate of 75/8%. Select s 75/8% senior subordinated notes are unsecured senior subordinated obligations and are subordinated in right of payment to all of our senior indebtedness, including obligations under our senior secured credit facility. All of our subsidiaries that guarantee our senior secured credit facility and, as required by the indenture governing Select s 75/8% senior subordinated notes, specified future subsidiaries will guarantee Select s 75/8% senior subordinated notes on an unsecured senior subordinated basis. Select may redeem some or all of Select s 75/8% senior subordinated notes prior to February 1, 2010 at a price equal to 100% of the principal amount plus accrued and unpaid interest and a make-whole premium. Thereafter, Select may redeem some or all of Select s 75/8% senior subordinated notes at the following percentages of principal amount plus accrued and unpaid interest:

	Redemption Price
February 1, 2010 to January 31, 2011	103.813%
February 1, 2011 to January 31, 2012	102.542%
February 1, 2012 to January 31, 2013	101.271%
Beginning on February 1, 2013 and thereafter	100.000%

If a change in control as defined in the indenture occurs, Select must offer to repurchase Select s 75/8% senior subordinated notes at 101% of the principal amount of the notes, plus accrued and unpaid interest. Select s 75/8% senior subordinated notes are subject to customary negative covenants and restrictions on actions by Select and its subsidiaries including, without limitation, restrictions on additional indebtedness, investments, asset dispositions outside the ordinary course of business, liens, the declaration or payment of dividends and transactions with affiliates, among other restrictions.

In December 2008, we paid approximately $1.0 million to repurchase and retire a portion of Select s 75/8% senior subordinated notes. The notes had a carrying value of $2.0 million. A gain on early retirement of debt in the amount of $0.9 million was recognized on the transaction which was net of the write-off of the unamortized deferred financing costs related to the debt. During the first quarter of 2009, we paid approximately $19.0 million to repurchase and retire additional 75/8% senior subordinated notes. These notes had a carrying value of $31.5 million. A gain on early retirement of debt in the amount of $11.8 million was recognized, which was net of the write-off of unamortized deferred financing costs related to the debt. During the second quarter 2009, we paid approximately $11.1 million to repurchase and retire additional 75/8% senior subordinated notes with a carrying value of $15.0 million. A gain on early retirement of debt in the amount of $3.6 million was recognized which was net of the write-off of unamortized

deferred financing costs related to the debt.

Holdings Senior Floating Rate Notes

On September 29, 2005, we sold $175.0 million of the senior floating rate notes, which bear interest at a rate per annum, reset semi-annually, equal to the 6-month LIBOR plus 5.75%. Interest is payable semi-annually in arrears on March 15 and September 15 of each year, with the principal due in full on September 15, 2015. The senior floating rate notes are general unsecured obligations of ours and are not guaranteed by us or any of our subsidiaries. In connection with the issuance of the senior floating rate notes, Select entered into two interest rate swap

transactions for a period of four years. The notional amount of the interest rate swaps is $175.0 million. The variable interest rate of the debt was 7.7% and the fixed rate after the swaps was 10.2% at June 30, 2009. We may redeem some or all of the senior floating rate notes prior to September 15, 2009 at a price equal to 100% of the principal amount plus accrued and unpaid interest and a make-whole premium. Thereafter, we may redeem some or all of the notes at the following percentages of principal amount plus accrued and unpaid interest:

	Redemption Price
September 15, 2009 to January 31, 2010	102.000%
February 1, 2010 to January 31, 2011	101.000%
Beginning on February 1, 2011 and thereafter	100.000%

At any time before September 15, 2008, we may redeem either all remaining outstanding senior floating rate notes or up to 35% of the aggregate principal amount of the senior floating rate notes at 100% of the aggregate principal amount so redeemed plus a premium equal to the interest rate per annum of the senior floating rate notes applicable on the date on which the notice of redemption is given, plus accrued and unpaid interest, with the proceeds of one or more equity offerings or equity contributions to our equity capital from the net proceeds of one or more equity offerings by any direct or indirect parent of ours, provided that either no senior floating rate notes remain outstanding immediately following such redemption or at least 65% of the originally issued aggregate principal amount of the senior floating rate notes remains outstanding after such redemption and the redemption occurs within 90 days of the date of the closing of such equity offering or equity contribution. Upon the occurrence of certain change of control events, we will be required to offer to repurchase all or a portion of the senior floating rate notes at a purchase price equal to 101% of the principal amount of the notes, plus accrued and unpaid interest. The senior floating rate notes are subject to customary negative covenants and restrictions on actions by us and our subsidiaries including, without limitation, restrictions on additional indebtedness, investments, asset dispositions outside the ordinary course of business, liens, the declaration or payment of dividends and transactions with affiliates, among other restrictions.

The Indenture governing the senior floating rate notes, or the Holdings Indenture, requires us, so long as any of the senior floating rate notes are outstanding, to furnish to the trustee and the holders of the senior floating rate notes (1) all quarterly and annual financial information that would be required to be contained in a filing with the SEC on Forms 10-Q and 10-K if we were required to file such forms, including Management s Discussion and Analysis of Financial Condition and Results of Operations that describes our consolidated financial condition and results of operations and, with respect to annual information only, a report thereon by our independent registered public accountants, and (2) all current reports that would be required to be filed with the SEC on Form 8-K if we were required to file such reports. These obligations can be satisfied either by filing such forms with either the SEC or directly to the trustee under the Holdings Indenture. The Holdings Indenture also provides that so long as any of the senior floating rate notes remain outstanding, we will furnish upon request to any beneficial owner of the senior floating rate notes or any prospective purchaser of the senior floating rate notes the information required to be delivered pursuant to Rule 144A(d)(4) under the Securities Act. The Holdings Indenture further provides that so long as the senior floating rate notes are outstanding and prior to an initial public offering of our common stock, we will host, with the participation of management, quarterly and annual earnings conference calls within five business days after such quarterly or annual financial information is required to be furnished under the Holdings Indenture. The conference calls must be reasonably accessible to all holders of the senior floating rate notes and should cover such matters as would customarily be covered in quarterly or annual earnings conference calls by an issuer with securities registered under the Exchange Act. The Indenture governing Select s 75/8% senior subordinated notes contains the same reporting requirements, except there is no requirement to hold quarterly conference calls.

In August 2009, we paid approximately $6.5 million to repurchase and retire senior floating rate notes with a carrying value of $7.7 million.

Holdings 10% Senior Subordinated Notes

Concurrently with the consummation of the Merger Transactions, we issued to WCAS Capital Partners IV, L.P., an investment fund affiliated with Welsh Carson, and Rocco A. Ortenzio, Robert A. Ortenzio and certain other

investors who are members of or affiliated with the Ortenzio family, $150.0 million in aggregate principal amount of our 10% senior subordinated notes. The proceeds from this issuance of our 10% senior subordinated notes was contributed by Holdings to Select as equity. Our 10% senior subordinated notes will mature on December 31, 2015.

Our senior secured credit facility and the indenture governing our 10% senior subordinated notes contain certain restrictions on Select s ability to pay dividends to Holdings for the purpose of paying cash interest on our 10% senior subordinated notes. See Senior Secured Credit Facility. Our 10% senior subordinated notes bear interest at a rate of 10% per annum, except that if any interest payment is not paid in cash, such unpaid amount will be multiplied by 1.2 and added to the outstanding principal amount of the holding company notes (with the result that such unpaid interest will have accrued at an effective rate of 12% instead of 10%). Interest on our 10% senior subordinated notes is payable semi-annually in arrears on February 1 and August 1 of each year.

Our 10% senior subordinated notes may be prepaid, in whole or in part, without premium or penalty. In addition, our 10% senior subordinated notes are subject to mandatory prepayment in the event of any change of control, initial public offering or sale of all or substantially all our assets, however, the holders of our 10% senior subordinated notes have waived their right to prepayment in connection with this offering. Our senior secured credit facility and the indenture governing our 10% senior subordinated notes contain certain restrictions on Select s ability to pay dividends to us for the purpose of making principal payments on our 10% senior subordinated notes. Our 10% senior subordinated notes are subordinate in right of payment to Holdings guaranty of our senior secured credit facility on the terms set forth in our 10% senior subordinated notes.

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SHARES ELIGIBLE FOR FUTURE SALE

Prior to this offering, there has been no market for shares of our Common Stock. We cannot predict the effect, if any, future sales of shares of our Common Stock, or the availability for future sale of shares of our Common Stock, will have on the market price of shares of our Common Stock prevailing from time to time. The sale of substantial amounts of shares of our Common Stock in the market, or the perception that such sales could occur, could harm the prevailing market price of shares of the Common Stock.

Sale of Restricted Shares

Upon completion of this offering, we will have 156,092,873 shares of common stock outstanding. Of these shares, the shares sold in this offering, plus any shares sold upon exercise of the underwriters over-allotment option, will be freely tradable without restriction under the Securities Act, except for any shares purchased by our affiliates as that term is defined in Rule 144 under the Securities Act. In general, affiliates include executive officers, directors, and 10% stockholders. Shares purchased by affiliates will remain subject to the resale limitations of Rule 144.

Upon completion of this offering, 126,092,873 shares of common stock will be restricted securities, as that term is defined in Rule 144 under the Securities Act. These restricted securities are eligible for public sale only if they are registered under the Securities Act or if they qualify for an exemption from registration under Rules 144 or 701 under the Securities Act, which are summarized below.

As a result of the lock-up agreements described below and the provisions of Rule 144 and Rule 701 of the Securities Act, the shares of our common stock (excluding the shares sold in this offering) will be available for sale in the public market as follows:

30,000,000 shares will be eligible for sale on the date of this prospectus; and

125,090,669 shares will be eligible for sale upon the expiration of the lock-up agreements, as more particularly described below, beginning 180 days after the date of this prospectus; and

In addition, upon completion of this offering 822,336 shares may be issued upon the exercise of vested options. Of this amount 87,116 shares issuable upon the exercise of vested options will only be eligible for future sale upon the expiration of look-up agreements beginning 180 days after the date of this prospectus.

Lock-Up Agreements

Our directors, executive officers and certain other stockholders will enter into lock-up agreements in connection with this offering, generally providing that they will not offer, sell, contract to sell, or grant any option to purchase or otherwise dispose of our common stock or any securities exercisable for or convertible into our common stock owned by them for a period of at least 180 days after the date of this prospectus without the prior written consent of the underwriters. Despite possible earlier eligibility for sale under the provisions of Rules 144 and 701, shares subject to lock-up agreements will not be salable until these agreements expire or are waived by the underwriters. Approximately 80.1% of our outstanding shares of common stock after the consummation of this offering will be subject to such lock-up agreements. These agreements are more fully described in Underwriting.

In the event that at least two of the four representatives of the underwriters agree in writing, such representatives may at any time and without notice release all or any portion of the securities subject to the lock-up agreements. The

representatives of the underwriters have advised us that they have no current intention of releasing any shares subject to a lock-up agreement. The release of any lock-up would be considered by the representatives of the underwriters on a case-by-case basis. In considering any request to release shares covered by a lock-up agreement, the representatives of the underwriters would consider circumstances of emergency and hardship. No agreement has been made between the underwriters and us or any of our stockholders pursuant to which the representatives of the underwriters will waive the lock-up restrictions.

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Rule 144

Generally, Rule 144 (as amended effective February 15, 2008) provides that an affiliate who has met the six month holding period for beneficial ownership of restricted shares of our common stock will be entitled to sell on the open market in brokers transactions, within any three-month period, a number of shares that does not exceed the greater of:

- 1% of the number of shares of common stock then outstanding, which will equal 1,560,929 shares immediately after this offering; or

- the average weekly trading volume of the common stock during the four calendar weeks preceding the filing of a notice on Form 144 with respect to such sale.

In addition, sales under Rule 144 are subject to requirements with respect to manner of sale, notice, and the availability of current public information about us.

In the event that any person who is deemed to be our affiliate purchases shares of our common stock in this offering or acquires shares of our common stock pursuant to one of our employee benefits plans, sales under Rule 144 of the shares held by that person are subject to the volume limitations and other restrictions described in the preceding two paragraphs.

The volume limitation, manner of sale and notice provisions described above will not apply to sales by non-affiliates. For purposes of Rule 144, a non-affiliate is any person or entity who is not our affiliate at the time of sale and has not been our affiliate during the preceding three months. Once we have been a reporting company for 90 days, a non-affiliate who has beneficially owned restricted shares of our common stock for six months may rely on Rule 144 provided that certain public information regarding us is available. The six month holding period increases to one year in the event we have not been a reporting company for at least 90 days. However, a non-affiliate who has beneficially owned the restricted shares proposed to be sold for at least one year will not be subject to any restrictions under Rule 144 regardless of how long we have been a reporting company.

Rule 701

Under Rule 701, each of our employees, officers, directors, and consultants who purchased shares pursuant to a written compensatory plan or contract is eligible to resell these shares 90 days after the effective date of this offering in reliance upon Rule 144, but without compliance with specific restrictions. Rule 701 provides that affiliates may sell their Rule 701 shares under Rule 144 without complying with the holding period requirement and that non-affiliates may sell their shares in reliance on Rule 144 without complying with the holding period, public information, volume limitation, or notice provisions of Rule 144.

Form S-8 Registration Statements

We intend to file one or more registration statements on Form S-8 under the Securities Act as soon as practicable after the completion of this offering for shares issued upon the exercise of options and shares to be issued under our employee benefit plans. As a result, any such options or shares will be freely tradable in the public market. We have granted options to purchase 1,488,002 shares of our common stock, 822,336 of which have vested and are exercisable. However, such shares held by affiliates will still be subject to the volume limitation, manner of sale, notice, and public information requirements of Rule 144 unless otherwise resalable under Rule 701.

MATERIAL U.S. FEDERAL TAX CONSIDERATIONS FOR NON-UNITED STATES HOLDERS

The following discussion is a general summary of the material U.S. federal tax consequences of the ownership and disposition of our common stock applicable to non-U.S. holders. As used herein, a non-U.S. holder means a beneficial owner of our common stock that is not a U.S. person or a partnership for U.S. federal income tax purposes, and that will hold shares of our common stock as capital assets (i.e., generally, for investment). For U.S. federal income tax purposes, a U.S. person includes:

- an individual who is a citizen or resident of the United States;
- a corporation (or other business entity treated as a corporation) created or organized in the United States or under the laws of the United States, any state thereof or the District of Columbia;
- an estate the income of which is subject to United States federal income taxation; or
- a trust that (1) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons, or (2) otherwise has elected to be treated as a U.S. domestic trust.

This summary does not consider specific facts and circumstances that may be relevant to a particular non-U.S. holder s tax position and does not consider U.S. state and local or non-U.S. tax consequences. It also does not consider non-U.S. holders subject to special tax treatment under the U.S. federal income tax laws (including partnerships or other pass-through entities, banks and insurance companies, regulated investment companies, real estate investment trusts, dealers in securities, holders of our common stock held as part of a straddle, hedge, conversion transaction or other risk-reduction transaction, controlled foreign corporations, passive foreign investment companies, companies that accumulate earnings to avoid U.S. federal income tax, foreign tax-exempt organizations, former U.S. citizens or residents and persons who hold or receive common stock as compensation). This summary is based on provisions of the U.S. Internal Revenue Code of 1986, as amended, or the Code, applicable Treasury regulations, administrative pronouncements of the U.S. Internal Revenue Service, or IRS, and judicial decisions, all as in effect on the date hereof, and all of which are subject to change, possibly on a retroactive basis, and different interpretations.

Each prospective non-U.S. holder should consult its tax advisor with respect to the U.S. federal, state, local and non-U.S. income, estate and other tax consequences of holding and disposing of our common stock.

U.S. Trade or Business Income

For purposes of this discussion, dividend income, and gain on the sale or other taxable disposition of our common stock, will be considered to be U.S. trade or business income if such dividend income or gain is (1) effectively connected with the conduct by a non-U.S. holder of a trade or business within the United States and (2) in the case of a non-U.S. holder that is eligible for the benefits of an income tax treaty with the United States, attributable to a permanent establishment (or, for an individual, a fixed base) maintained by the non-U.S. holder in the United States. Generally, U.S. trade or business income is not subject to U.S. federal withholding tax (provided the non-U.S. holder complies with applicable certification and disclosure requirements); instead, U.S. trade or business income is subject to U.S. federal income tax on a net income basis at regular U.S. federal income tax rates in the same manner as a U.S. person. Any U.S. trade or business income received by a non-U.S. holder that is a corporation also may be subject to a branch profits tax at a 30% rate, or at a lower rate prescribed by an applicable income tax treaty, under specific circumstances.

Dividends

Distributions of cash or property that we pay on our common stock will be taxable as dividends for U.S. federal income tax purposes to the extent paid from our current or accumulated earnings and profits (as determined under U.S. federal income tax principles). A non-U.S. holder generally will be subject to U.S. federal withholding tax at a 30% rate, or at a reduced rate prescribed by an applicable income tax treaty, on any dividends received in respect of our common stock. If the amount of a distribution exceeds our current and accumulated earnings and profits, such excess first will be treated as a tax-free return of capital to the extent of the non-U.S. holder s tax basis in our

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common stock, and thereafter will be treated as capital gain. See Dispositions of Our Common Stock below. In order to obtain a reduced rate of U.S. federal withholding tax under an applicable income tax treaty, a non-U.S. holder will be required to provide a properly executed IRS Form W-8BEN (or appropriate substitute or successor form) certifying its entitlement to benefits under the treaty. A non-U.S. holder of our common stock that is eligible for a reduced rate of U.S. federal withholding tax under an income tax treaty may obtain a refund or credit of any excess amounts withheld by filing an appropriate claim for a refund with the IRS. A non-U.S. holder should consult its own tax advisor regarding its possible entitlement to benefits under an income tax treaty.

The U.S. federal withholding tax does not apply to dividends that are U.S. trade or business income, as described above, of a non-U.S. holder who provides a properly executed IRS Form W-8ECI (or appropriate substitute or successor form), certifying that the dividends are effectively connected with the non-U.S. holder s conduct of a trade or business within the United States.

Dispositions of Our Common Stock

A non-U.S. holder generally will not be subject to U.S. federal income or withholding tax in respect of any gain on a sale or other disposition of our common stock unless:

the gain is U.S. trade or business income, as described above;

the non-U.S. holder is an individual who is present in the United States for 183 or more days in the taxable year of the disposition and meets other conditions; or

we are or have been a U.S. real property holding corporation, which we refer to as USRPHC, under section 897 of the Code at any time during the shorter of the five year period ending on the date of disposition and the non-U.S. holder s holding period for our common stock.

In general, a corporation is a USRPHC if the fair market value of its U.S. real property interests equals or exceeds 50% of the sum of the fair market value of its worldwide (domestic and foreign) real property interests and its other assets used or held for use in a trade or business. For this purpose, real property interests include land, improvements, and associated personal property. We believe that we currently are not a USRPHC. In addition, based on our financial statements and current expectations regarding the value and nature of our assets and other relevant data, we do not anticipate becoming a USRPHC, although there can be no assurance these conclusions are correct or might not change in the future based on changed circumstances. If we are found to be a USRPHC, a non-U.S. holder, nevertheless, will not be subject to U.S. federal income or withholding tax in respect of any gain on a sale or other disposition of our common stock so long as our common stock is regularly traded on an established securities market as defined under applicable Treasury regulations and a non-U.S. holder owns, actually and constructively, 5% or less of our common stock during the shorter of the five year period ending on the date of disposition and such non-U.S. holder s holding period for our common stock. Prospective investors should be aware that no assurance can be given that our common stock will be so regularly traded when a non-U.S. holder sells its shares of our common stock.

Information Reporting and Backup Withholding Requirements

We must annually report to the IRS and to each non-U.S. holder any dividend income that is subject to U.S. federal withholding tax, or that is exempt from such withholding tax pursuant to an income tax treaty. Copies of these information returns also may be made available under the provisions of a specific treaty or agreement to the tax authorities of the country in which the non-U.S. holder resides. Under certain circumstances, the Code imposes a backup withholding obligation (currently at a rate of 28%) on certain reportable payments. Dividends paid to a non-U.S. holder of our common stock generally will be exempt from backup withholding if the non-U.S. holder

provides a properly executed IRS Form W-8BEN (or appropriate substitute or successor form) or otherwise establishes an exemption.

The payment of the proceeds from the disposition of our common stock to or through the U.S. office of any broker, U.S. or foreign, will be subject to information reporting and possible backup withholding unless the owner certifies as to its non-U.S. status under penalties of perjury or otherwise establishes an exemption, provided that the broker does not have actual knowledge or reason to know that the holder is a U.S. person or that the conditions of

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any other exemption are not, in fact, satisfied. The payment of the proceeds from the disposition of common stock to or through a non-U.S. office of a non-U.S. broker will not be subject to information reporting or backup withholding unless the non-U.S. broker has certain types of relationships with the United States, or a U.S. related person as defined under applicable Treasury regulations. In the case of the payment of the proceeds from the disposition of our common stock to or through a non-U.S. office of a broker that is either a U.S. person or a U.S. related person, the Treasury regulations require information reporting (but not the backup withholding) on the payment unless the broker has documentary evidence in its files that the owner is a non-U.S. holder and the broker has no knowledge to the contrary. Non-U.S. holders should consult their own tax advisors on the application of information reporting and backup withholding to them in their particular circumstances (including upon their disposition of our common stock).

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from a payment to a non-U.S. holder will be refunded or credited against the non-U.S. holder s U.S. federal income tax liability, if any, if the non-U.S. holder provides the required information to the IRS.

Federal Estate Tax

Individual Non-U.S. holders and entities the property of which is potentially includible in such an individual s gross estate for U.S. federal estate tax purposes (for example, a trust funded by such an individual and with respect to which the individual has retained certain interests or powers), should note that, absent an applicable treaty benefit, the common stock will be treated as U.S. situs property subject to U.S. federal estate tax.

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UNDERWRITERS

Under the terms and subject to the conditions contained in an underwriting agreement dated the date of this prospectus, the underwriters named below, for whom Goldman, Sachs & Co., Morgan Stanley & Co. Incorporated, Merrill Lynch, Pierce, Fenner & Smith Incorporated and J.P. Morgan Securities Inc. are acting as representatives, have severally agreed to purchase, and we have agreed to sell to them, the number of shares indicated below:

Name	Number of Shares
Goldman, Sachs & Co.	7,500,000
Morgan Stanley & Co. Incorporated	6,000,000
Merrill Lynch, Pierce, Fenner & Smith Incorporated	5,400,000
J.P. Morgan Securities Inc.	5,700,000
Wells Fargo Securities, LLC	3,000,000
RBC Capital Markets Corporation	2,400,000
Total	30,000,000

The underwriters are offering the shares of common stock subject to their acceptance of the shares from us and subject to prior sale. The underwriting agreement provides that the obligations of the several underwriters to pay for and accept delivery of the shares of common stock offered by this prospectus are subject to the approval of certain legal matters by their counsel and to certain other conditions. The underwriters are obligated to take and pay for all of the shares of common stock offered by this prospectus if any such shares are taken. However, the underwriters are not required to take or pay for the shares covered by the underwriters over-allotment option described below.

The underwriters initially propose to offer part of the shares of common stock directly to the public at the public offering price listed on the cover page of this prospectus and part to certain dealers at a price that represents a concession not in excess of $0.36 a share under the public offering price. After the initial offering of the shares of common stock, the offering price and other selling terms may from time to time be varied by the representatives.

We have granted to the underwriters an option, exercisable for 30 days from the date of this prospectus, to purchase up to an aggregate of 4,500,000 additional shares of common stock at the public offering price listed on the cover page of this prospectus, less underwriting discounts and commissions. The underwriters may exercise this option solely for the purpose of covering over-allotments, if any, made in connection with the offering of the shares of common stock offered by this prospectus. To the extent the option is exercised, each underwriter will become obligated, subject to certain conditions, to purchase about the same percentage of the additional shares of common stock as the number listed next to the underwriter s name in the preceding table bears to the total number of shares of common stock listed next to the names of all underwriters in the preceding table. If the underwriters option is exercised in full, the total price to the public would be approximately $345,000,000, the total underwriters discounts and commissions would be approximately $20,700,000 and the total proceeds to us would be approximately $324,300,000.

The underwriters have informed us that they do not intend sales to discretionary accounts to exceed 5% of the total number of shares of common stock offered by them.

Our common stock has been approved for quotation on the New York Stock Exchange under the symbol SEM.

The following table shows the per share and total underwriting discounts and commissions that we are to pay to the underwriters in connection with this offering. These amounts are shown assuming both no exercise and full exercise of the underwriters option to purchase additional shares of our common stock.

	Discounts and Commissions Payable by Us	
	No Exercise	**Full Exercise**
Per share	$ 0.60	$ 0.60
Total	$ 18,000,000	$ 20,700,000

We will pay all of the expenses of the offering, including those incurred if the underwriters exercise their overallotment option. We estimate that the expenses of this offering other than underwriting discounts and commissions payable by us will be $3.3 million.

We, our directors, our executive officers and certain of our other stockholders have agreed that, without the prior written consent of at least two of the four representatives of the underwriters, we and they will not, during the period ending 180 days after the date of this prospectus:

offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, lend, or otherwise transfer or dispose of directly or indirectly, any shares of common stock or any securities convertible into or exercisable or exchangeable for common stock;

file any registration statement with the SEC relating to the offering of any shares of common stock or any securities convertible into or exercisable or exchangeable for common stock; or

enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the common stock;

whether any such transaction described above is to be settled by delivery of common stock or such other securities, in cash or otherwise. The restrictions described in this paragraph do not apply to:

the sale of shares to the underwriters;

the issuance by us of shares of common stock upon the exercise of an option or a warrant or the conversion of a security outstanding on the date of this prospectus of which the underwriters have been advised in writing;

the issuance by us of options to purchase our common stock under stock option or similar plans as in effect on the date of the underwriting agreement and as described in this prospectus;

sales of shares of common stock underlying employee stock options that are scheduled to expire during such 180 day period in connection with cashless exercises of those stock options by former employees of our company; provided that no filing under Section 16(a) of the Exchange Act shall be required or shall be voluntarily made in connection with such transaction other than a filing on Form 5 after the expiration of such 180 day period;

the filing by us of any registration statement on Form S-8 relating to the offering of securities pursuant to the terms of a stock option or similar plan in effect on the date of the underwriting agreement and described in this prospectus;

transfers of common stock or any security convertible into common stock as a bona fide gift (including for estate planning purposes), by will or intestacy, or transfers to any trust for the direct or indirect benefit of the transferor or the immediate family of the transferor; provided that no filing under Section 16(a) of the Exchange Act shall be required or shall be voluntarily made in connection with such transaction other than a filing on Form 5 after the expiration of such 180 day period; and provided further that the transferee agrees with the underwriters to be bound by such restrictions for the remainder of such 180 day period;

the establishment of a trading plan pursuant to Rule 10b5-1 under the Exchange Act for the transfer of shares of common stock, provided that such plan does not provide for the transfer of common stock during the restricted periods;

distributions by a stockholder who is subject to a lock-up of common stock or any security convertible into common stock to limited partners, limited liability company members, affiliates or stockholders of such stockholder; provided that no filing under Section 16(a) of the Exchange Act shall be required or shall be voluntarily made in connection with such transaction other than a filing on Form 5 after the expiration of such 180 day period; and provided further that the transferee agrees with the underwriters to be bound by such restrictions for the remainder of such 180 day period; or

transactions by any person other than us relating to common stock or other securities acquired in open market transactions after the completion of the offering of the shares hereby; provided that no filing under Section 16(a) of the Exchange Act shall be required or shall be voluntarily made in connection with such transaction.

The 180-day restricted period described above is subject to extension such that, in the event that either (1) during the last 17 days of the restricted period, we issue an earnings release or material news or a material event relating to us occurs or (2) prior to the expiration of the restricted period, we announce that we will release earnings results during the 16-day period beginning on the last day of the applicable restricted period, the lock-up restrictions described above will, subject to limited exceptions, continue to apply until the expiration of the 18-day period beginning on the earnings release or the occurrence of the material news or material event.

In order to facilitate the offering of the common stock, the underwriters may engage in transactions that stabilize, maintain or otherwise affect the price of the common stock. Specifically, the underwriters may sell more shares than they are obligated to purchase under the underwriting agreement, creating a short position. A short sale is covered if the short position is no greater than the number of shares available for purchase by the underwriters under the over allotment option. The underwriters can close out a covered short sale by exercising the over allotment option or purchasing shares in the open market. In determining the source of shares to close out a covered short sale, the underwriters will consider, among other things, the open market price of shares compared to the price available under the over allotment option. The underwriters may also sell shares in excess of the over allotment option, creating a naked short position. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common stock in the open market after pricing that could adversely affect investors who purchase in the offering. As an additional means of facilitating the offering, the underwriters may bid for, and purchase, shares of common stock in the open market to stabilize the price of the common stock. The underwriting syndicate may also reclaim selling concessions allowed to an underwriter or a dealer for distributing the common stock in the offering, if the syndicate repurchases previously distributed common stock to cover syndicate short positions or to stabilize the price of the common stock. These activities may raise or maintain the market price of the common stock above independent market levels or prevent or slow a decline in the market price of the common stock. The underwriters are not required to engage in these activities, and may end any of these activities at any time.

Conflicts of Interest

From time to time, certain of the underwriters and/or their respective affiliates have directly and indirectly engaged in various financial advisory, investment banking and commercial banking services for us and our affiliates, for which they received customary compensation, fees and expense reimbursement. In particular, affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated, J.P. Morgan Securities Inc. and Wells Fargo Securities, LLC, underwriters in

this offering, are parties to our senior secured credit facility. In addition, affiliates of J.P. Morgan Securities Inc. have in the past provided treasury and security services to us for customary fees. Our senior secured credit facility was negotiated on an arms length basis and contains customary terms pursuant to which the lenders receive customary fees. We will use a portion of the proceeds from this offering to repay amounts outstanding under this credit facility. See Use of Proceeds. As a result of these repayments, each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, J.P. Morgan Securities Inc. and Wells Fargo Securities, LLC

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may receive a portion of the net proceeds from this offering and an affiliate of Wells Fargo Securities, LLC will receive more than 5% of the net proceeds from the offering. Accordingly, this offering will be conducted in compliance with the applicable provisions of NASD Rule 2720 of Financial Industry Regulatory Authority (FINRA). Pursuant to those rules, a qualified independent underwriter, as defined by the FINRA rules, must participate in the preparation of the prospectus and perform its usual standard of due diligence with respect to the prospectus. Goldman, Sachs & Co. has agreed to act as qualified independent underwriter for the offering and to perform a due diligence investigation and review and participate in the preparation of the prospectus. Wells Fargo Securities, LLC will not confirm sales of the common stock to any account over which they have discretionary authority without the prior written approval of the customer. In addition, from time to time, certain of the underwriters and their affiliates may effect transactions for their own account or the account of customers, and hold on behalf of themselves or their customers, long or short positions in our debt or equity securities or loans, and may do so in the future.

We and the underwriters have agreed to indemnify each other against certain liabilities, including liabilities under the Securities Act.

Directed Share Program

At our request, the underwriters have reserved for sale, at the initial public offering price, up to 900,000 shares offered in this prospectus for our directors, officers, employees, business associates and related persons. The number of shares of common stock available for sale to the general public will be reduced to the extent such persons purchase such reserved shares. Any reserved shares which are not so purchased will be offered by the underwriters to the general public on the same basis as the other shares offered in this prospectus.

Pricing of the Offering

Prior to this offering, there has been no public market for the shares of common stock. The initial public offering price will be determined by negotiations among us and the representatives of the underwriters. Among the factors to be considered in determining the initial public offering price will be the future prospects of us and our industry in general and our sales, earnings and certain other financial operating information in recent periods, and the price-earnings ratios, price-sales ratios, market prices of securities and certain financial and operating information of companies engaged in activities similar to us.

Selling Restrictions

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), each underwriter has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the Relevant Implementation Date) it has not made and will not make an offer of shares to the public in that Relevant Member State prior to the publication of a prospectus in relation to the shares which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive, except that it may, with effect from and including the Relevant Implementation Date, make an offer of shares to the public in that Relevant Member State at any time:

(a) to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;

(b) to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than 43,000,000 and (3) an annual net turnover of more than 50,000,000, as shown in

its last annual or consolidated accounts;

(c) to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the representatives for any such offer; or

(d) in any other circumstances which do not require the publication by the Issuer of a prospectus pursuant to Article 3 of the Prospectus Directive.

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For the purposes of this provision, the expression an offer of shares to the public in relation to any shares in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the shares to be offered so as to enable an investor to decide to purchase or subscribe the shares, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

Each underwriter has represented and agreed that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act 2000 (FSMA)) received by it in connection with the issue or sale of the shares in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the shares in, from or otherwise involving the United Kingdom.

The shares may not be offered or sold by means of any document other than (i) in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), or (ii) to professional investors within the meaning of the Securities and Futures Ordinance (Cap.571, Laws of Hong Kong) and any rules made thereunder, or (iii) in other circumstances which do not result in the document being a prospectus within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), and no advertisement, invitation or document relating to the shares may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to shares which are or are intended to be disposed of only to persons outside Hong Kong or only to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder.

This prospectus has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the shares may not be circulated or distributed, nor may the shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the SFA), (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the shares are subscribed or purchased under Section 275 by a relevant person which is: (a) a corporation (which is not an accredited investor) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries rights and interest in that trust shall not be transferable for 6 months after that corporation or that trust has acquired the shares under Section 275 except: (1) to an institutional investor under Section 274 of the SFA or to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA; (2) where no consideration is given for the transfer; or (3) by operation of law.

The securities have not been and will not be registered under the Securities and Exchange Law of Japan (the Securities and Exchange Law) and each underwriter has agreed that it will not offer or sell any securities, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

LEGAL MATTERS

The validity of the shares offered hereby will be passed upon for us by Dechert LLP, Philadelphia, Pennsylvania. Certain legal matters in connection with this offering will be passed upon for the underwriters by Davis Polk & Wardwell LLP, New York, New York.

EXPERTS

The consolidated financial statements as of December 31, 2007 and 2008 and for the years ended December 31, 2006, 2007 and 2008 included in this prospectus have been so included in reliance on the reports of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

INDUSTRY DATA

This prospectus includes industry data that we derived from internal company records, publicly available information and industry publications and surveys. Industry publications and surveys generally state that the information contained therein has been obtained from sources believed to be reliable.

WHERE YOU CAN FIND MORE INFORMATION

This prospectus is part of a registration statement on Form S-1 that we have filed with the Securities and Exchange Commission under the Securities Act of 1933 covering the common stock we are offering. As permitted by the rules and regulations of the SEC, this prospectus omits certain information contained in the registration statement. For further information with respect to us and our common stock, you should refer to the registration statement and to its exhibits and schedules. We make reference in this prospectus to certain of our contracts, agreements and other documents that are filed as exhibits to the registration statement. For additional information regarding those contracts, agreements and other documents, please see the exhibits attached to this registration statement.

You can read the registration statement and the exhibits and schedules filed with the registration statement or any reports, statements or other information we have filed or file, at the public reference facilities maintained by the SEC at the public reference room (Room 1580), 100 F Street, N.E., Washington, D.C. 20549. You may also obtain copies of the documents from such offices upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room. You may also request copies of the documents upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a web site that contains reports and other information regarding registrants (including us) that file electronically with the SEC, which you can access at http://www.sec.gov.

In addition, you may request copies of this filing and such other reports as we may determine or as the law requires at no cost, by telephone at (717) 972-1100, or by mail to Select Medical Holdings Corporation, 4714 Gettysburg Road, Mechanicsburg, Pennsylvania 17055, Attention: Investor Relations.

Upon completion of this offering, we will become subject to the information and periodic reporting requirements of the Exchange Act, and, in accordance with such requirements, will file periodic reports, proxy statements and other information with the SEC. These periodic reports, proxy statements and other information will be available for inspection and copying at the public reference facilities and website of the SEC referred to above.

SELECT MEDICAL HOLDINGS CORPORATION

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
of Select Medical Holdings Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in stockholders equity and comprehensive income and of cash flows present fairly, in all material respects, the financial position of Select Medical Holdings Corporation and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in the notes to the consolidated financial statements, the Company changed the manner in which it accounts for non-controlling interests (Note 1) and for unvested restricted stock in the calculation of earnings per share (Note 14) as of January 1, 2009.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, Pennsylvania
March 23, 2009, except with respect to our opinion on the consolidated financial statements insofar as it relates to the effects of the change in accounting for non-controlling interests (Note 1) and for unvested restricted stock in the calculation of earnings per share (Note 14), as to which the date is June 18, 2009

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SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED BALANCE SHEETS

	December 31, 2007[1]	December 31, 2008[1]
	(in thousands, except share and per share amounts)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 4,529	$ 64,260
Accounts receivable, net of allowance for doubtful accounts of $55,856 and $57,052 in 2007 and 2008, respectively	271,406	312,418
Current deferred tax asset	48,988	61,925
Prepaid income taxes	8,162	7,362
Other current assets	22,507	20,897
Total Current Assets	355,592	466,862
Property and equipment, net	487,026	471,065
Goodwill	1,499,485	1,506,661
Other identifiable intangibles	79,172	74,078
Assets held for sale	14,607	12,542
Other assets	59,164	48,261
Total Assets	$ 2,495,046	$ 2,579,469
LIABILITIES AND EQUITY		
Current Liabilities:		
Bank overdrafts	$ 21,124	$ 21,130
Current portion of long-term debt and notes payable	7,749	9,046
Accounts payable	73,847	72,496
Accrued payroll	59,483	66,380
Accrued vacation	33,080	37,109
Accrued interest	36,781	37,032
Accrued restructuring	15,484	8,108
Accrued other	78,242	91,482
Due to third party payors	15,072	5,709
Total Current Liabilities	340,862	348,492
Long-term debt, net of current portion	1,747,886	1,770,879
Non-current deferred tax liability	22,966	42,918
Other non-current liabilities	52,266	67,709
Total Liabilities	2,163,980	2,229,998
Commitments and Contingencies		
	491,194	515,872

Preferred stock Authorized shares (liquidation preference is $491,194 and $515,872 in 2007 and 2008, respectively)		
Stockholders Equity:		
Common stock, $0.001 par value, 250,000,000 shares authorized, 205,166,000 and 204,885,000 shares issued and outstanding in 2007 and 2008, respectively	205	205
Capital in excess of par	(291,247)	(289,382)
Retained earnings	130,716	128,185
Accumulated other comprehensive loss	(5,563)	(13,212)
Total Select Medical Holdings Corporation Stockholders Equity	(165,889)	(174,204)
Non-controlling interest	5,761	7,803
Total Equity	(160,128)	(166,401)
Total Liabilities and Equity	$ 2,495,046	$ 2,579,469

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies Recent Accounting Pronouncements, for additional information.

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

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SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Year Ended December 31,		
	2006[(1)]	2007[(1)]	2008[(1)]
	(in thousands, except per share data)		
Net operating revenues	$ 1,851,498	$ 1,991,666	$ 2,153,362
Costs and expenses:			
Cost of services	1,484,632	1,660,049	1,791,841
General and administrative	43,514	42,863	45,523
Bad debt expense	18,810	37,572	47,804
Depreciation and amortization	46,668	57,297	71,786
Total costs and expenses	1,593,624	1,797,781	1,956,954
Income from operations	257,874	193,885	196,408
Other income and expense:			
Gain on early retirement of debt			912
Other expense		(167)	
Interest income	1,293	2,103	471
Interest expense	(131,831)	(140,155)	(145,894)
Income from continuing operations before income taxes	127,336	55,666	51,897
Income tax expense	43,521	18,699	26,063
Income from continuing operations	83,815	36,967	25,834
Income from discontinued operations, net of tax (includes pre-tax gain of $13,950 in 2006)	12,818		
Net income	96,633	36,967	25,834
Less: Net income attributable to non-controlling interests	1,754	1,537	3,393
Net income attributable to Select Medical Holdings Corporation	94,879	35,430	22,441
Less: Preferred dividends	22,663	23,807	24,972
Net income (loss) available to common and preferred stockholders	$ 72,216	$ 11,623	$ (2,531)
Amounts attributable to Select Medical Holdings Corporation:			
Income from continuing operations, net of tax	$ 82,401	$ 35,430	$ 22,441
Discontinued operations, net of tax	12,478		
Net income	$ 94,879	$ 35,430	$ 22,441

Income (loss) per common share[(2)]:						
Basic:						
Income (loss) from continuing operations	$	0.26	$	0.05	$	(0.01)
Discontinued operations, net of tax		0.06				
Income (loss) per common share	$	0.32	$	0.05	$	(0.01)
Diluted:						
Income (loss) from continuing operations	$	0.26	$	0.05	$	(0.01)
Discontinued operations, net of tax		0.06				
Income (loss) per common share	$	0.32	$	0.05	$	(0.01)
Unaudited pro forma income (loss) per common share:						
Basic					$	0.18
Diluted					$	0.18

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies Recent Accounting Pronouncements for additional information.

(2) Adjusted for the Adoption of FASB Staff Position EITF 03-6-1 Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 14 for additional information.

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

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SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)

			Select Medical Holdings Corporation Stockholders					
	Total	Comprehensive Income	Common Stock Issued	Common Stock Par Value	Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non-Controlling Interests[1]
Balance at December 31, 2005	$ (240,302)		205,408	$ 205	$ (299,028)	$ 48,808	$ 5,357	$ 4,356
Net income	96,293	$ 96,293				94,879		1,414
Unrealized gain on interest rate swap, net of tax	1,438	1,438					1,438	
Changes in foreign currency translation	924	924					924	
Sale of foreign subsidiary	(2,831)	(2,831)					(2,831)	
Total comprehensive income	95,824	$ 95,824						
Issuance and vesting of restricted stock	3,770		200	1	3,769			
Cancellation of restricted stock awards	(1)		(680)	(1)				
Repurchase of common shares	(10)		(24)		(10)			
Stock option expense	13				13			
Purchase of subsidiary shares from non-controlling interests	(1,742)							(1,742)
	(1,746)							(1,746)

Distributions to non-controlling interests								
Other	284							284
Accretion of dividends on preferred stock	(22,663)					(22,663)		
Balance at December 31, 2006	(166,573)		204,904	205	(295,256)	121,024	4,888	2,566
Net income	36,967	$ 36,967				35,430		1,537
Unrealized loss on interest rate swap, net of tax	(10,451)	(10,451)					(10,451)	
Total comprehensive income	26,516	$ 26,516						
Cumulative impact of change in accounting for uncertainties in income taxes (FIN No. 48 Note 11)	(1,931)					(1,931)		
Issuance and vesting of restricted stock	3,923		200		3,923			
Exercise of stock options	66		65		66			
Repurchase of common shares	(3)		(3)		(3)			
Stock option expense	23				23			
Sale of subsidiary shares to non-controlling interest	3,271							3,271
Distributions to non-controlling interests	(1,698)							(1,698)
Other	85							85
Accretion of dividends on preferred stock	(23,807)					(23,807)		
	(160,128)		205,166	205	(291,247)	130,716	(5,563)	5,761

Balance at December 31, 2007								
Net income	25,834	$ 25,834				22,441		3,393
Unrealized loss on interest rate swap, net of tax	(7,649)	(7,649)					(7,649)	
Total comprehensive income	18,185	$ 18,185						
Vesting of restricted stock	2,037				2,037			
Exercise of stock options	90		82		90			
Repurchase of common shares	(318)		(363)		(318)			
Stock option expense	56				56			
Sale of subsidiary shares to non-controlling interest	1,378							1,378
Purchase of subsidiary shares from non-controlling interests	(789)							(789)
Distributions to non-controlling interests	(1,957)							(1,957)
Other	17							17
Accretion of dividends on preferred stock	(24,972)					(24,972)		
Balance at December 31, 2008	$ (166,401)		204,885	$ 205	$ (289,382)	$ 128,185	$ (13,212)	$ 7,803

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies Recent Accounting Pronouncements, for additional information.

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

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SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Year Ended December 31,		
	2006[1]	2007[1]	2008[1]
	(in thousands)		
Operating Activities			
Net income	$ 96,633	$ 36,967	$ 25,834
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	46,844	57,297	71,786
Provision for bad debts	18,897	37,572	47,804
Gain on early retirement of debt			(912)
Loss (gain) from disposal of assets and sale of business units	(11,507)	2,424	546
Non-cash stock compensation expense	3,782	3,746	2,093
Amortization of debt discount	1,176	1,325	1,492
Deferred income taxes	13,327	2,460	21,756
Changes in operating assets and liabilities, net of effects from acquisition of businesses:			
Accounts receivable	30,804	(75,540)	(88,545)
Other current assets	2,015	1,406	8,230
Other assets	6,441	6,251	16,913
Accounts payable	12,081	(112)	(1,351)
Due to third-party payors	711	2,186	(9,363)
Accrued expenses	6,447	10,031	11,155
Net cash provided by operating activities	227,651	86,013	107,438
Investing Activities			
Purchases of property and equipment	(155,096)	(166,074)	(56,504)
Proceeds from sale of business units	74,966	9,605	2,666
Proceeds from sale of property		6,438	743
Insurance proceeds			281
Changes in restricted cash	2,010	4,335	
Acquisition of businesses, net of cash acquired	(3,361)	(236,980)	(7,624)
Net cash used in investing activities	(81,481)	(382,676)	(60,438)
Financing Activities			
Borrowings on revolving credit facility	215,000	449,000	407,000
Payments on revolving credit facility	(300,000)	(329,000)	(377,000)
Credit facility term loan borrowings		100,000	
Payments on credit facility term loan	(5,800)	(6,550)	(6,800)
Repurchase of 75/8% senior subordinated notes			(1,040)
Principal payments on seller and other debt	(721)	(1,323)	(5,630)
Proceeds from (repayment of) bank overdrafts	(7,142)	8,911	6

Repurchase of common and preferred stock	(41)	(14)	(612)
Proceeds from issuance of restricted stock		200	
Proceeds from issuance of common stock		66	90
Payment of initial public offering costs			(1,326)
Distributions to non-controlling interests	(1,762)	(1,698)	(1,957)
Net cash provided by (used in) financing activities	(100,466)	219,592	12,731
Effect of exchange rate changes on cash and cash equivalents	35		
Net increase (decrease) in cash and cash equivalents	45,739	(77,071)	59,731
Cash and cash equivalents at beginning of period	35,861	81,600	4,529
Cash and cash equivalents at end of period	$ 81,600	$ 4,529	$ 64,260
Supplemental Cash Flow Information			
Cash paid for interest	$ 124,251	$ 134,527	$ 135,838
Cash paid for taxes	$ 22,572	$ 9,009	$ 5,313

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies Recent Accounting Pronouncements, for additional information.

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

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Significant Accounting Policies

Business Description

Select Medical Corporation (Select) was formed in December 1996 and commenced operations during February 1997 upon the completion of its first acquisition. Select Medical Holdings Corporation (Holdings) was formed in October 2004 for the purpose of effecting a leverage buyout of Select, which was a publicly traded entity. Holdings is owned by an investor group that includes Welsh, Carson, Anderson, & Stowe, IX, LP (Welsh Carson), Thoma Cressey Bravo (Thoma Cressey) and members of the Company s senior management. On February 24, 2005, Select merged with a subsidiary of Holdings which resulted in Select becoming a wholly-owned subsidiary of Holdings (the Merger). The Merger and related transactions are referred to in this report as the Merger.

The Company provides long term acute care hospital services and inpatient acute rehabilitative hospital care through its specialty hospital segment and provides physical, occupational and speech rehabilitation services through its outpatient rehabilitation segment. The Company s specialty hospital segment consists of hospitals designed to serve the needs of acute patients and hospitals designed to serve patients that require intensive medical rehabilitation care. Patients in the Company s long term acute care hospitals typically suffer from serious and often complex medical conditions that require a high degree of care. Patients in the Company s acute medical rehabilitation hospitals typically suffer from debilitating injuries including traumatic brain and spinal cord injuries, and require rehabilitation care in the form of physical, psychological, social and vocational rehabilitation services. The Company s outpatient rehabilitation business consists of clinics and contract services that provide physical, occupational and speech rehabilitation services. The Company s outpatient rehabilitation patients are typically diagnosed with musculoskeletal impairments that restrict their ability to perform normal activities of daily living. The Company operated 96, 87 and 93 specialty hospitals at December 31, 2006, 2007 and 2008, respectively. At December 31, 2006, 2007 and 2008, the Company operated 544, 999 and 956 outpatient clinics, respectively. At December 31, 2006, 2007 and 2008, the Company had operations in the District of Columbia and 32, 42 and 42 states, respectively.

Unaudited Pro Forma Income (Loss) Per Common Share

In July 2008, the Board of Directors authorized management to file a registration statement with the Securities and Exchange Commission for the Company to sell shares of its common stock to the public. If the initial public offering is completed, 22,148,453 shares of the Company s preferred stock will convert into shares of common stock as of the closing of the offering. Because the preferred stock value increases due to accrued dividends, the number of common shares issued in the conversion are not constant. If the offering had closed on June 30, 2009, the number of common shares issued in the conversion would have been 63,559,714 shares. Unaudited pro forma income per common share basic and diluted, as adjusted for the assumed conversion of the preferred stock to common stock and the reverse split of common stock, is set forth in the accompanying consolidated statement of operations.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, its majority owned subsidiaries, limited liability companies and limited partnerships the Company and its subsidiaries control through ownership of general and limited partnership or membership interests. All significant intercompany balances and transactions are eliminated in consolidation.

Use of Estimates

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

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents are stated at cost which approximates market value.

Accounts Receivable and Allowance for Doubtful Accounts

The Company reports accounts receivable at estimated net realizable amounts from services rendered from federal, state, managed care health plans, commercial insurance companies, workers compensation and patients. Substantially all of the Company s accounts receivable are related to providing healthcare services to patients. Collection of these accounts receivable is the Company s primary source of cash and is critical to its operating performance. The Company s primary collection risks relate to non-governmental payors who insure these patients and deductibles, co-payments and self-insured amounts owed by the patient. Deductibles, co-payments and self-insured amounts are an immaterial portion of the Company s net accounts receivable balance and accounted for approximately 0.3% of the net accounts receivable balance before doubtful accounts at both December 31, 2007 and December 31, 2008. The Company s general policy is to verify insurance coverage prior to the date of admission for a patient admitted to the Company s hospitals or in the case of the Company s outpatient rehabilitation clinics, the Company verifies insurance coverage prior to their first therapy visit. The Company s estimate for the allowance for doubtful accounts is calculated by providing a reserve allowance based upon the age of an account balance. Generally the Company has reserved as uncollectible all governmental accounts over 365 days and non-governmental accounts over 180 days from discharge. This method is monitored based on historical cash collections experience. Collections are impacted by the effectiveness of the Company s collection efforts with non-governmental payors and regulatory or administrative disruptions with the fiscal intermediaries that pay the Company s governmental receivables.

The Company has historically collected substantially all of its third-party insured receivables (net of contractual allowances) which include receivables from governmental agencies. The Company reviews its overall reserve adequacy by monitoring historical cash collections as a percentage of net revenue less the provision for bad debts.

Uncollected accounts are written off the balance sheet when they are turned over to an outside collection agency, or when management determines that the balance is uncollectible, whichever occurs first.

Property and Equipment

Property and equipment are stated at cost net of accumulated depreciation. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets or the term of the lease, as appropriate. The general range of useful lives is as follows:

Leasehold improvements	5 years
Furniture and equipment	3 - 20 years
Buildings	40 years

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144), the Company reviews the realizability of long-lived assets whenever

events or circumstances occur which indicate recorded costs may not be recoverable. Gains or losses related to the retirement or disposal of property and equipment are reported as a component of income from operations.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist primarily of cash balances and trade receivables. The Company invests its excess cash with large financial institutions. The

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company grants unsecured credit to its patients, most of whom reside in the service area of the Company s facilities and are insured under third-party payor agreements. Because of the geographic diversity of the Company s facilities and non-governmental third-party payors, Medicare represents the Company s only significant concentration of credit risk.

Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management provides a valuation allowance for net deferred tax assets when it is more likely than not that such net deferred tax assets will not be recovered.

On January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN No. 48 clarifies the recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. See Note 11 for information concerning the Company s unrecognized tax benefits, interest and penalties.

Intangible Assets

Effective January 1, 2002, the Company adopted SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). Under SFAS No. 142, goodwill and other intangible assets with indefinite lives are no longer subject to periodic amortization but are instead reviewed annually, or more frequently if impairment indicators arise. These reviews require the Company to estimate the fair value of its identified reporting units and compare those estimates against the related carrying values. For each of the reporting units, the estimated fair value is determined utilizing the expected present value of the future cash flows of the units.

Identifiable assets and liabilities acquired in connection with business combinations accounted for under the purchase method are recorded at their respective fair values. Deferred income taxes have been recorded to the extent of differences between the fair value and the tax basis of the assets acquired and liabilities assumed. Company management has allocated the intangible assets between identifiable intangibles and goodwill. Intangible assets other than goodwill primarily consist of the values assigned to trademarks, non-compete agreements, certificates of need, accreditation and contract therapy relationships. Management believes that the estimated useful lives established are reasonable based on the economic factors applicable to each of the intangible assets.

The approximate useful life of each class of intangible assets is as follows:

Trademarks	Indefinite
Certificates of need	Indefinite
Accreditation	Indefinite
Non-compete agreements	6 - 7 years
Contract therapy relationships	5 years

In accordance with SFAS No. 144, the Company reviews the realizability of long-lived assets and certain definite lived intangible assets whenever events or circumstances occur which indicate recorded costs may not be recoverable.

If the expected future cash flows (undiscounted) are less than the carrying amount of such assets, the Company recognizes an impairment loss for the difference between the carrying amount of the assets and their estimated fair value.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Due to Third-Party Payors

Due to third-party payors represents the difference between amounts received under interim payment plans from third-party payors, principally Medicare and Medicaid, for services rendered and amounts estimated to be reimbursed by those third-party payors upon settlement of cost reports.

Insurance Risk Programs

Under a number of the Company s insurance programs, which include the Company s employee health insurance program, its workers compensation, professional liability insurance programs and certain components under its property and casualty insurance program, the Company is liable for a portion of its losses. In these cases the Company accrues for its losses under an occurrence-based principle whereby the Company estimates the losses that will be incurred in a respective accounting period and accrues that estimated liability. Where the Company has substantial exposure, actuarial methods are utilized in estimating the losses. In cases where the Company has minimal exposure, losses are estimated by analyzing historical trends. These programs are monitored quarterly and estimates are revised as necessary to take into account additional information. At December 31, 2007 and 2008 respectively, the Company had recorded a liability of $58.9 million and $62.9 million related to these programs.

Fair Value Measurements

In the first quarter of 2008, the Company adopted SFAS No. 157, Fair Value Measurements with the exception of the application of the statement to non-recurring non-financial assets and non-financial liabilities, which has been deferred until January 1, 2009. This standard defines fair value, provides guidance for measuring fair value and requires certain disclosures. This standard does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements.

SFAS No. 157 discusses valuation techniques, such as the market approach, the income approach and the cost approach. The statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels as follows:

> Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.
>
> Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.
>
> Level 3: Unobservable inputs that reflect the reporting entity s own assumptions.

The Company measures its interest rate swaps at fair value on a recurring basis. The Company determines the fair value of its interest rate swaps based on financial models that consider current and future market interest rates and adjustments for non-performance risk. The Company considers the inputs utilized in the valuation process to be Level 2 in the fair value hierarchy. The fair value of the Company s interest rate swaps was a liability of $28.5 million at December 31, 2008 of which $18.9 million was reported as a current liability in accrued other and $9.6 million was

reported in other long-term liabilities.

Non-Controlling Interests

The interests held by other parties in subsidiaries, limited liability companies and limited partnerships owned and controlled by the Company are reported in the equity section of the consolidated balance sheets as non-controlling interests. Non-controlling interests reported in the consolidated statements of operations reflect the respective interests in the income or loss of the subsidiaries, limited liability companies and limited partnerships attributable to the other parties, the effect of which is removed from the Company s consolidated results of operations.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue Recognition

Net operating revenues consists primarily of patient and contract therapy revenues and are recognized as services are rendered.

Patient service revenue is reported net of provisions for contractual allowances from third-party payors and patients. The Company has agreements with third-party payors that provide for payments to the Company at amounts different from its established billing rates. The differences between the estimated program reimbursement rates and the standard billing rates are accounted for as contractual adjustments, which are deducted from gross revenues to arrive at net operating revenues. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, per diem and per visit payments. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Accounts receivable resulting from such payment arrangements are recorded net of contractual allowances.

A significant portion of the Company s net operating revenues are generated directly from the Medicare program. Net operating revenues generated directly from the Medicare program represented approximately 53%, 48% and 46% of the Company s net operating revenues for the years ended December 31, 2006, 2007 and 2008, respectively. Approximately 22% and 26% of the Company s accounts receivable (after allowances for contractual adjustments but before doubtful accounts) at December 31, 2007 and 2008, respectively, are from this payor source. As a provider of services to the Medicare program, the Company is subject to extensive regulations. The inability of any of the Company s specialty hospitals or clinics to comply with regulations can result in changes in that specialty hospital s or clinic s net operating revenues generated from the Medicare program.

Contract therapy revenues are comprised primarily of billings for services rendered to nursing homes, hospitals, schools and other third parties under the terms of contractual arrangements with these entities.

Other Comprehensive Income

The Company used the local currency as the functional currency for its Canadian operations. Income statement items were translated at average exchange rates prevailing during the year. The resulting translation adjustments impacting other comprehensive income were recorded as a separate component of stockholders equity. The Company sold its Canadian operations on March 1, 2006 and removed the accumulated other comprehensive income related to the cumulative translation adjustment. This component of other comprehensive income was included in the calculation of the gain on the sale of the Company s Canadian operations.

Included in accumulated other comprehensive income (loss) at December 31, 2006, 2007 and 2008 was cumulative income of $4.9 million (net of tax), cumulative losses of $5.6 million (net of tax) and cumulative losses of $13.2 million (net of tax), respectively, on interest rate swaps accounted for as cash flow hedges.

Financial Instruments and Hedging

Effective January 1, 2001, the Company adopted SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133). The Company has in the past entered into derivatives to manage interest rate and foreign exchange risks. Derivatives are limited in use and not entered into for speculative purposes. The Company has entered

into interest rate swaps to manage interest rate risk on a portion of its long-term borrowings. All derivatives are recognized at fair value on the balance sheet. The effective portion of gains or losses on interest rate swaps designated as hedges are initially deferred in stockholders equity as a component of other comprehensive income. These deferred gains or losses are subsequently reclassified into earnings as an adjustment to interest expense over the same period in which the related interest payments being hedged are recognized in expense. The ineffective portion of changes in fair value of the interest rate swaps are immediately recognized in the other income and expense section of the consolidated statement of operations.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Refer to Note 15 for information regarding interest rate swaps the Company entered into during 2005 and 2007.

Recent Accounting Pronouncements

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. 141R-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies (FSP 141R-1). FSP 141R-1 amends the provisions in Statement of Financial Accounting Standards (SFAS) No. 141R, Business Combinations, Revised (SFAS No. 141R), for the initial recognition and measurement, subsequent measurement and accounting, and disclosures for assets and liabilities arising from contingencies in business combinations. FSP 141R-1 eliminates the distinction between contractual and non-contractual contingencies, including the initial recognition and measurement criteria in SFAS No. 141R and instead carries forward most of the provisions in SFAS No. 141, Business Combinations, for acquired contingencies. FSP 141R-1 is effective for contingent assets and contingent liabilities acquired in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of FSP 141R-1 did not have a material impact on the Company s consolidated financial statements.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which will require that the fair value disclosures for all financial instruments within the scope of SFAS No. 107, Disclosures about Fair Value of Financial Instruments, be included in interim financial statements. This FSP also requires entities to disclose the method and significant assumptions used to estimate the fair value of financial instruments on an interim and annual basis and to highlight any changes from prior periods. FSP FAS 107-1 and APB 28-1 will be effective for interim periods ending after June 15, 2009. The adoption of FSP 107-1 and APB 28-1 is not expected to have a material impact on the Company s consolidated financial statements.

In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, provides additional guidance for estimating fair value in accordance with SFAS No. 157 when the volume and level of activity for the asset or liability have decreased significantly. FSP FAS 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly. The provisions of FSP FAS 157-4 are effective for the Company s interim period ending on June 30, 2009. The adoption of FSP FAS 157-4 is not expected to have a material impact on the Company s consolidated financial statements.

On January 1, 2009, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 160, Non-controlling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 (SFAS No. 160). Upon adoption of this standard, minority interest is now referred to as non-controlling interest and has been reclassified from the mezzanine section of the balance sheet to the equity section. In addition, non-controlling interest is now deducted from net income to obtain net income attributable to the Company. The accompanying consolidated financial statements have been retrospectively adjusted to give effect to the requirements of SFAS No. 160.

In October 2008, the FASB issued FASB Staff Position (FSP) FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP FAS 157-3). FSP FAS 157-3 clarifies the application of SFAS No. 157, Fair Value Measurements (SFAS No. 157), in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 is effective upon issuance, including prior periods for which financial statements have not

been issued. Revisions resulting from a change in the valuation technique or its application should be accounted for as a change in accounting estimate following the guidance in SFAS No. 154, Accounting Changes and Error Corrections. The application of FSP FAS 157-3 had no impact on the Company s consolidated financial statements.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In April 2008, the FASB issued FSP No. 142-3, Determination of Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R, Business Combinations (SFAS No. 141R). FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset should be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements should be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The adoption of FSP 142-3 by the Company will result in changes related to presentation and disclosure of the Company s intangible assets but the Company believes that the adoption of this FSP will not materially impact its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS No. 161). This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity s derivative instruments and hedging activities and their effects on the entity s financial position, financial performance and cash flows. SFAS No. 161 applies to all derivative instruments within the scope of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133) as well as related hedged items, bifurcated derivatives and non-derivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to SFAS No. 161 must provide more robust qualitative disclosures and expanded quantitative disclosures. SFAS No. 161 is effective prospectively for financial statements issued for fiscal years beginning after November 15, 2008, with early application permitted. Adoption of this statement by the Company will result in changes related to presentation and disclosure of the Company s interest rate swaps but will not affect the Company s results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations (SFAS No. 141R), which replaces SFAS No. 141. SFAS No. 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. In addition, adjustments to valuation allowances, deferred taxes and uncertain tax positions relating to acquisitions occurring before the effective date of SFAS No. 141R will no longer be recorded as an adjustment to goodwill but will be adjusted through income tax expense. SFAS No. 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. This statement will be applied prospectively and will not result in any changes to the Company s historical financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS No. 157 relate to the definition of fair value, the methods used to measure fair value and the expanded disclosures about fair value measurements. In February 2008, the FASB issued FSP 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under

Statement 13 (FSP 157-1) and FSP 157-2, Effective Date of FASB Statement No. 157 (FSP 157-2). FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. Effective for the first quarter of 2008, the Company adopted SFAS No. 157 except as it applies to those non-financial assets and non-financial liabilities addressed in FSP 157-2. The adoption of SFAS No. 157 had no effect on the Company s consolidated financial statements. The Company has evaluated the effect of FSP 157-2 and has determined that it will have no effect on the Company s consolidated financial statements.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Acquisitions

For the Year Ended December 31, 2006

The Company repurchased minority interests of certain subsidiaries in the outpatient rehabilitation segment. Total consideration for these transactions totaled $3.3 million in cash.

For the Year Ended December 31, 2007

On May 1, 2007, Select completed the acquisition of substantially all of the outpatient rehabilitation division (the Division) of HealthSouth Corporation. At the closing, Select acquired 539 outpatient rehabilitation clinics. On June 30, 2007, one additional facility located in Washington, D.C. was acquired upon the receipt of regulatory approval. The closing of the purchase of 29 additional outpatient rehabilitation clinics that was deferred pending certain state regulatory approvals was completed as of October 31, 2007 and resulted in the release of an additional $23.4 million of the purchase price. The aggregate purchase price of $245.0 million was reduced by approximately $7.0 million at closing for assumed indebtedness and other matters. The amount of the consideration was derived through arm s length negotiations. Select funded the acquisition through borrowings under its senior secured credit facility and cash on hand. The factors that were considered when deciding to acquire the Division and determining the purchase price that resulted in goodwill included the historical earnings of the acquired outpatient rehabilitation clinics, general and administrative cost saving opportunities that could be achieved by utilizing the Company s infrastructure and the benefits that could be achieved with patients and commercial payors by having a larger network of outpatient rehabilitation clinics.

The results of operations of the Division have been included in the Company s consolidated financial statements since May 1, 2007. The Company has included the operations of the Division in its outpatient rehabilitation segment.

The purchase price was allocated to tangible and identifiable intangible assets and liabilities based upon estimates of fair value, with the remainder allocated to goodwill. In accordance with the provisions of SFAS No. 142, no amortization of goodwill has been recorded.

The purchase price allocation is as follows (in thousands):

Cash paid, net of cash acquired	$ 236,899
Fair value of net tangible assets acquired:	
Accounts receivable	35,743
Other current assets	12,596
Property and equipment	39,347
Other assets	808
Current liabilities	(14,104)
Long-term debt	(2,381)
Net tangible assets acquired	72,009

Non-compete, 5-year	5,100
Restructuring reserve	(18,700)
Goodwill	178,490
	$ 236,899

The Company also acquired an interest in a rehabilitation hospital and purchased the assets of two outpatient rehabilitation clinics. Consideration for these transactions totaled approximately $0.1 million in cash.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the Year Ended December 31, 2008

The Company repurchased minority interest in one of its outpatient clinics and acquired the assets of three outpatient rehabilitation businesses. The aggregate consideration for these transactions totaled $5.7 million in cash and a $1.0 million note payable. The Company also acquired two specialty hospitals for $0.3 million in cash and paid a $1.6 million working capital adjustment related to the acquisition of the Division.

Information with respect to all businesses acquired in purchase transactions is as follows:

	For the Year Ended December 31,		
	2006	2007	2008
		(in thousands)	
Cash paid (net of cash acquired)	$ 3,261	$ 236,980	$ 7,624
Notes issued			1,001
	3,261	236,980	8,625
Liabilities assumed		36,458	253
	3,261	273,438	8,878
Fair value of assets acquired, principally accounts receivable and property and equipment		88,625	1,120
Non-compete agreement		5,100	
Trademark		800	
Minority interest relieved	1,581		461
Cost in excess of fair value of net assets acquired (goodwill)	$ 1,680	$ 178,913	$ 7,297

The following pro forma unaudited results of operations have been prepared assuming the acquisition of the Division occurred at the beginning of the periods presented. The acquisitions of the other businesses acquired are not reflected in this pro forma information as their impact is not material. These results are not necessarily indicative of results of future operations nor of the results that would have actually occurred had the acquisition been consummated as of the beginning of the periods presented.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Unaudited pro forma net revenue, net income and earnings per share for the years ended December 31, 2006 and 2007 as if the acquisition occurred as of January 1, 2006 and January 1, 2007 are as follows:

	For the Year Ended December 31, 2006	2007
	(unaudited) (in thousands, except per share data)	
Net revenue	$ 2,162,162	$ 2,092,114
Net income attributable to Select Medical Holdings Corporation	100,657	36,046
Earnings per share(1)		
Basic income per common share	$ 0.34	$ 0.05
Diluted income per common share	$ 0.34	$ 0.05

(1) Adjusted for the adoption of FASB Staff Position EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 14 for additional information.

3. Discontinued Operations and Assets and Liabilities Held For Sale

On March 1, 2006, the Company sold all of the issued and outstanding shares of its wholly-owned subsidiary, CBIL, for approximately C$89.8 million (US$79.0 million). CBIL operated 109 outpatient rehabilitation clinics in seven Canadian provinces. The Company operated all of its Canadian activity through CBIL. CBIL s operating results have been classified as discontinued operations and cash flows have been included with continuing operations for the year ended December 31, 2006. Previously, the operating results of this subsidiary were included in the Company s outpatient rehabilitation segment.

Summarized income statement information relating to discontinued operations of CBIL is as follows:

	For the Year Ended December 31, 2006 (in thousands)
Net revenue	$ 12,902
Income from discontinued operations before income tax expense[1]	15,547
Income tax expense	3,069
Income from discontinued operations, net of tax	$ 12,478

(1) Income from discontinued operations before income tax expense for the twelve months ended December 31, 2006 includes a gain on sale of approximately $14.0 million.

In December 2006, the Company sold a group of legal entities that operated outpatient rehabilitation clinics. The Company recorded a note receivable in the amount of $8.4 million related to this sale. These legal entities were sold at an amount that approximated their carrying value. These legal entities were originally acquired as part of the Company s acquisition of the NovaCare Physical Rehabilitation and Occupational Health Group in 1999.

At December 31, 2006, the asset held for sale related to a building that the Company acquired in connection with its acquisition of Kessler Rehabilitation Corporation in 2003. The building was sold in June 2007 for approximately $4.5 million and a loss on the sale of $0.5 million was recognized. Also during the year ended December 31, 2007, the Company sold land for approximately $1.9 million. No gain or loss was recognized on this

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

sale. At December 31, 2007, the assets held for sale totaling $14.6 million related to three properties the Company expected to sell within the next year. The Company adjusted the carrying values of these properties to fair market value by recording an impairment loss of $2.7 million during the year ended December 31, 2007. During the year ended December 31, 2008 the Company sold two of these properties for approximately $3.8 million and recognized an additional loss on these sales of $0.4 million.

During the year ended December 31, 2007, the Company sold its interest in four business units for aggregate consideration of $12.2 million. The Company received cash of $9.6 million and recorded notes receivable of $2.6 million related to these transactions.

At December 31, 2008, the Company had $12.5 million in assets held for sale. These assets consist of the three properties that the Company intends to sell within the next year. Also, during the year ended December 31, 2008, the Company sold interests in two of its hospitals for $2.7 million. The Company recognized a gain on these transactions of $1.1 million.

4. Property and Equipment

Property and equipment consists of the following:

	December 31, 2007 (in thousands)	December 31, 2008 (in thousands)
Land	$ 40,582	$ 48,606
Leasehold improvements	72,010	82,228
Buildings	171,736	252,475
Furniture and equipment	175,964	206,316
Construction-in-progress	104,862	6,710
	565,154	596,335
Less: accumulated depreciation and amortization	78,128	125,270
Total property and equipment	$ 487,026	$ 471,065

Depreciation expense was $38.7 million, $48.6 million and $62.6 million for the years ended December 31, 2006, 2007 and 2008, respectively.

5. Intangible Assets

Goodwill and certain other indefinite-lived intangible assets are no longer amortized, but instead are subject to periodic impairment evaluations under SFAS No. 142, Goodwill and Other Intangible Assets. The Company s most recent impairment assessment was completed during the fourth quarter of 2008 utilizing financial information as of

October 1, 2008, which indicated that there was no impairment with respect to goodwill or other recorded intangible assets. The majority of the Company s goodwill resides in its specialty hospital reporting unit. In performing periodic impairment tests, the fair value of the reporting unit is compared to the carrying value, including goodwill and other intangible assets. If the carrying value exceeds the fair value, an impairment condition exists, which results in an additional fair value review of all assets in the reporting unit. To the extent that the recomputed value of the goodwill is less than the carrying value, an impairment loss would result. Impairment tests are required to be conducted at least annually, or when events or conditions occur that might suggest a possible impairment. These events or conditions include, but are not limited to, a significant adverse change in the business environment, regulatory environment or legal factors; a current period operating or cash flow loss combined with a history of such losses or a projection of continuing losses; or a sale or disposition of a significant portion of a

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

reporting unit. The occurrence of one of these events or conditions could significantly impact an impairment assessment, necessitating an impairment charge. For purposes of goodwill impairment assessment, the Company has defined its reporting units as specialty hospitals, outpatient rehabilitation clinics and contract therapy with goodwill having been allocated among reporting units based on the relative fair value of those divisions when the Merger occurred in 2005 and based on subsequent acquisitions.

To determine the fair value of its reporting units, the Company used a discounted cash flow approach. Included in this analysis are assumptions regarding revenue growth rates, internal development of specialty hospitals and outpatient rehabilitation clinics, future EBITDA margin estimates, future selling, general and administrative expense rates and the industry s weighted average cost of capital and market multiples. The Company also must estimate residual values at the end of the forecast period and future capital expenditure requirements. Each of these assumptions requires the Company to use its knowledge of (1) its industry, (2) its recent transactions, and (3) reasonable performance expectations for its operations. If any one of the above assumptions changes or fails to materialize, the resulting decline in the Company s estimated fair value could result in a material impairment charge to the goodwill associated with any one of the reporting units.

Intangible assets consist of the following:

	As of December 31, 2007 (in thousands)	
	Gross Carrying Amount	Accumulated Amortization
Amortized Intangible Assets		
Contract therapy relationships	$ 20,456	$ (11,592)
Non-compete agreements	25,909	(11,219)
Total	$ 46,365	$ (22,811)
Indefinite-Lived Intangible Assets		
Goodwill	$ 1,499,485	
Trademarks	47,858	
Certificates of need	6,421	
Accreditations	1,339	
Total	$ 1,555,103	

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	As of December 31, 2008	
	Gross Carrying Amount	Accumulated Amortization
	(in thousands)	
Amortized Intangible Assets		
Contract therapy relationships	$ 20,456	$ (15,683)
Non-compete agreements	25,909	(15,958)
Total	$ 46,365	$ (31,641)
Indefinite-Lived Intangible Assets		
Goodwill	$ 1,506,661	
Trademarks	47,858	
Certificates of need	10,157	
Accreditations	1,339	
Total	$ 1,566,015	

Amortization expense for intangible assets with finite lives follows:

	For the Year Ended December 31		
	2006	2007	2008
	(in thousands)		
Amortization expense	$ 7,811	$ 8,491	$ 8,830

Amortization expense for the Company s intangible assets primarily relates to the amortization of the value associated with the non-compete agreements entered into in connection with the acquisitions of the Division, Kessler Rehabilitation Corporation and SemperCare Inc. and the value assigned to the Company s contract therapy relationships. The useful lives of the Division s non-compete, the Kessler non-compete, the SemperCare non-compete and the Company s contract therapy relationships are approximately five, six, seven and five years, respectively. Amortization expense related to these intangible assets for each of the next five years commencing January 1, 2009 is approximately as follows (in thousands):

Year	Amount
2009	$ 8,831
2010	4,247
2011	1,306

2012	340
2013	0

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The changes in the carrying amount of goodwill for the Company s reportable segments for the years ended December 31, 2007 and 2008 are as follows:

	Specialty Hospitals	Outpatient Rehabilitation (in thousands)	Total
Balance as of January 1, 2007	$ 1,227,533	$ 96,039	$ 1,323,572
Goodwill acquired during year	423	178,490	178,913
Goodwill related to sale of business		(3,000)	(3,000)
Balance as of December 31, 2007	1,227,956	271,529	1,499,485
Goodwill acquired during year		7,297	7,297
Other	(108)	(13)	(121)
Balance as of December 31, 2008	$ 1,227,848	$ 278,813	$ 1,506,661

6. Restructuring Reserves

In connection with the acquisition of the Division (Note 2), the Company recorded an estimated liability of $18.7 million in 2007 for business restructuring which was accounted for as additional purchase price. This reserve primarily included costs associated with workforce reductions and lease termination costs in accordance with the Company s restructuring plan.

The following summarizes the Company s restructuring activity:

	Lease Termination Costs	Severance	Other	Total
		(in thousands)		
January 1, 2006	$ 390	$	$	$ 390
Amounts paid in 2006	(165)			(165)
December 31, 2006	225			225
2007 acquisition restructuring reserve	12,063	5,775	862	18,700
Amounts paid in 2007	(1,611)	(1,830)		(3,441)
December 31, 2007	10,677	3,945	862	15,484
Amounts paid in 2008	(3,630)	(2,953)	(793)	(7,376)

December 31, 2008	$ 7,047	$ 992	$ 69	$ 8,108

The Company expects to pay out the remaining lease termination costs through 2016 and severance costs through 2009.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Long-term Debt and Notes Payable

The components of long-term debt and notes payable are shown in the following tables:

	December 31, 2007	December 31, 2008
	(in thousands)	
75/8% senior subordinated notes	$ 660,000	$ 658,000
Senior secured credit facility	783,300	806,500
10% senior subordinated notes	134,110	135,603
Senior floating rate notes	175,000	175,000
Seller notes	633	1,282
Other	2,592	3,540
Total debt	1,755,635	1,779,925
Less: current maturities	7,749	9,046
Total long-term debt	$ 1,747,886	$ 1,770,879

Senior Secured Credit Facility

On March 19, 2007, Select entered into an Amendment No. 2 and Waiver to its senior secured credit facility (Amendment No. 2), and on March 28, 2007, Select entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 increased the general exception to the prohibition on asset sales under Select s senior secured credit facility from $100.0 million to $200.0 million, relaxed certain financial covenants starting March 31, 2007 and waived Select s requirement to prepay certain term loan borrowings following its fiscal year ended December 31, 2006. The Incremental Facility Amendment provided to Select an incremental term loan of $100.0 million, the proceeds of which was used to pay a portion of the purchase price for the HealthSouth transaction.

On August 5, 2009, we entered into Amendment No. 3 to our senior secured credit facility with a group of holders of Tranche B term loans and JPMorgan Chase Bank, N.A., as administrative agent. Amendment No. 3 extended the maturity of $384.5 million principal amount of Tranche B term loans from February 24, 2012 to August 22, 2014. Holders of Tranche B term loans that extended the maturity of their Tranche B term loans now hold Tranche B-1 term loans that mature on August 22, 2014, and holders of Tranche B term loans that did not extend the maturity of their Tranche B term loans continue to hold Tranche B term loans that mature on February 24, 2012. The applicable rate for the Tranche B-1 term loans under our senior secured credit facility has increased to 3.75% for adjusted LIBOR loans and 2.75% for alternate base rate loans. We may apply future voluntary prepayments entirely to Tranche B term loans or pro rata between Tranche B term loans and Tranche B-1 term loans. Under the terms of Amendment No. 3, if, prior to August 5, 2011, our senior secured credit facility is amended to reduce the applicable rate for Tranche B-1 term loans, then we will be required to pay a fee in an amount equal to 1% of the outstanding Tranche B-1 term loans held

by those holders of Tranche B-1 term loans that agree to amend our senior secured credit facility to reduce the applicable rate. In addition, if, prior to August 5, 2011, we make any prepayment of Tranche B-1 term loans with proceeds of any term loan indebtedness, we will be required to pay a fee to holders of Tranche B-1 term loans in an amount equal to 1% of the outstanding Tranche B-1 term loans that are being prepaid.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

After giving effect to the Incremental Facility Amendment and Amendment No. 3, our senior secured credit facility provides for senior secured financing consisting of:

a $300.0 million revolving loan facility that will terminate on February 24, 2011, including both a letter of credit sub-facility and a swingline loan sub-facility,

$268.6 million in Tranche B term loans that mature on February 24, 2012, and

$384.5 million in Tranche B-1 term loans that mature on August 22, 2014.

The interest rates per annum applicable to loans, other than swingline loans and Tranche B-1 term loans, under our senior secured credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The interest rates per annum applicable to Tranche B-1 term loans under our senior credit facility are, at our option, equal to either an alternate base rate or an adjusted LIBOR rate for a three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The alternate base rate is the greater of (1) JPMorgan Chase Bank, N.A. s prime rate and (2) one-half of 1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate is determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The applicable margin percentage for borrowings under our revolving loans is subject to change based upon the ratio of Select s total indebtedness to consolidated EBITDA (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 1.50% for alternate base rate loans and (2) 2.50% for adjusted LIBOR loans. The applicable margin percentages for Tranche B term loans are (1) 1.00% for alternate base rate loans and (2) 2.00% for adjusted LIBOR loans. The applicable margin percentages for Tranche B-1 term loans are (1) 2.75% for alternate base rate loans and (2) 3.75% for adjusted LIBOR loans. The weighted average interest rate for the years ended December 31, 2007 and 2008 was 6.9% and 6.1%, respectively.

On the last business day of each calendar quarter Select is required to pay a commitment fee in respect of any unused commitment under the revolving credit facility. The annual commitment fee is currently 0.50% and is subject to adjustment based upon the ratio of Select s total indebtedness to its consolidated EBITDA (as defined in the credit agreement). Availability under the revolving credit facility at December 31, 2008 was approximately $121.0 million. Select is authorized to issue up to $50.0 million in letters of credit. Letters of credit reduce the capacity under the revolving credit facility and bear interest at applicable margins based on financial ratio tests. Approximately $29.0 million in letters of credit were outstanding at December 31, 2008.

The senior secured credit facility requires scheduled quarterly payments on the term loans each equal to $1.7 million per quarter through December 31, 2010, with the balance of the term loans paid in four equal quarterly installments thereafter.

The senior secured credit facility requires Select to comply on a quarterly basis with certain financial covenants, including an interest coverage ratio test and a maximum leverage ratio test, which financial covenants will become more restrictive over time. In addition, the senior secured credit facility includes various negative covenants, including

with respect to indebtedness, liens, investments, permitted businesses and transactions and other matters, as well as certain customary representations and warranties, affirmative covenants and events of default including payment defaults, breach of representations and warranties, covenant defaults, cross defaults to certain indebtedness, certain events of bankruptcy, certain events under ERISA, material judgments, actual or asserted failure of any guaranty or security document supporting the senior secured credit facility to be in full force and effect and change of control. If such an event of default occurs, the lenders under the senior secured credit facility are entitled to take various actions, including the acceleration of amounts due under the senior secured credit facility and all actions permitted to be taken by a secured creditor. As of December 31, 2008, Select was in compliance with all debt covenants related to the senior secured credit facility.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Select s senior secured credit facility is guaranteed by Holdings and substantially all of Select s current subsidiaries and will be guaranteed by substantially all of Select s future subsidiaries and secured by substantially all of its existing and future property and assets and by a pledge of its capital stock and the capital stock of its subsidiaries.

Senior Subordinated Notes

On February 24, 2005, EGL Acquisition Corp. sold $660.0 million of 75/8% Senior Subordinated Notes (the Notes) due 2015 which Select assumed in the Merger. The net proceeds of the offering were used to finance a portion of the Merger consideration, refinance certain of Select s existing indebtedness, and pay related fees and expenses. The Notes are unconditionally guaranteed on a senior subordinated basis by all of Select s wholly-owned subsidiaries (the Subsidiary Guarantors). Certain of Select s subsidiaries that were not wholly-owned by Select did not guarantee the Notes (the Non-Guarantor Subsidiaries). The guarantees of the Notes are subordinated in right of payment to all existing and future senior indebtedness of the Subsidiary Guarantors, including any borrowings or guarantees by those subsidiaries under the senior secured credit facility. The Notes rank equally in right of payment with all of Select s existing and future senior subordinated indebtedness and senior to all of Select s existing and future subordinated indebtedness. The Notes were not guaranteed by Holdings.

Prior to February 1, 2010, Select may redeem all or a portion of the Notes at a price equal to 100% of the principal amount plus accrued and unpaid interest to the redemption date and a make whole premium. Thereafter, Select will be entitled at its option to redeem all or a portion of the Notes at the following redemption prices (expressed in percentages of principal amount on the redemption date), plus accrued interest to the redemption date, if redeemed during the 12-month period commencing on February 1st of the years set forth below:

Year	Redemption Price
2010	103.813%
2011	102.542%
2012	101.271%
2013 and thereafter	100.000%

Select is not required to make any mandatory redemption or sinking fund payments with respect to the Notes. However, upon the occurrence of any change of control of Select, each holder of the Notes shall have the right to require Select to repurchase such holder s notes at a purchase price in cash equal to 101% of the principal amount thereof on the date of purchase plus accrued and unpaid interest, if any, to the date of purchase.

The indenture governing the Notes contains customary events of default and affirmative and negative covenants that, among other things, limit Select s ability and the ability of its restricted subsidiaries to incur or guarantee additional indebtedness, pay dividends or make other equity distributions, purchase or redeem capital stock, make certain investments, enter into arrangements that restrict dividends from subsidiaries, transfer and sell assets, engage in certain transactions with affiliates and effect a consolidation or merger. As of December 31, 2008, Select was in compliance with all debt covenants related to the senior subordinated notes.

In the three months ended December 31, 2008, Select repurchased a portion of the Notes outstanding for approximately $1.0 million. These notes had a carrying value of $2.0 million. A gain on early retirement of debt in the amount of $0.9 million was recognized on the transaction which included the write-off of the unamortized deferred financing costs related to the debt.

During the first quarter of 2009, Select repurchased a portion of the Notes outstanding for approximately $19.0 million. These notes had a carrying value of $31.5 million.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Senior Floating Rate Notes

On September 29, 2005, Holdings, whose primary asset is its investment in Select, issued $175.0 million of Senior Floating Rate Notes, due 2015 (the Holdings Notes). The Holdings Notes are senior unsecured obligations of Holdings and bear interest at a floating rate, reset semi-annually, equal to 6-month LIBOR plus 5.75%. Simultaneously with the financing, Select entered into two interest rate swap agreements, effectively fixing the interest rate of the notes for four years. The Holdings Notes are not guaranteed by Select or any of its subsidiaries.

Payment of interest expense on the Holdings Notes is expected to be funded through periodic dividends from Select. The terms of Select s senior secured credit facility, as well as the indenture governing Select s 75/8% Senior Subordinated Notes, and certain other agreements, restrict Select and certain of its subsidiaries from making payments or transferring assets to Holdings, including dividends, loans or other distributions. Such restrictions include prohibition of dividends in an event of default and limitations on the total amount of dividends paid to Holdings. In the event these agreements do not permit such subsidiaries to provide Holdings with sufficient distributions to fund interest and principal payments on the Holdings Notes when due, Holdings may default on its notes unless other sources of funding are available.

Proceeds from the offering were used to pay a special dividend of $175.0 million to stockholders of Holdings in September 2005. The payment of the special dividend triggered a payment obligation of $14.5 million under Holdings long-term incentive compensation plan, which was paid in September 2005 (Note 9).

Prior to September 15, 2009, Holdings may redeem all or a portion of the Holdings Notes at a price equal to 100% of the principal amount plus accrued and unpaid interest to the redemption date and a make-whole premium. Thereafter, Holdings may redeem some or all of the Holdings Notes at the redemption prices set forth below:

Year	Redemption Price
2009	102.00%
2010	101.00%
2011	100.00%

Holdings is not required to make any mandatory redemption or sinking fund payments with respect to the Holdings Notes. However, upon the occurrence of any change of control of Holdings, each holder of the Holdings Notes shall have the right to require Holdings to repurchase such notes at a purchase price in cash equal to 101% of the principal amount thereof on the date of purchase plus accrued and unpaid interest, if any, to the date of purchase.

The indenture governing the Holdings Notes contains customary events of default and affirmative and negative covenants that, among other things, limit Holdings ability and the ability of its restricted subsidiaries, including Select, to: incur additional indebtedness and issue or sell preferred stock; pay dividends on, redeem or repurchase capital stock; make certain investments; create certain liens; sell certain assets; incur obligations that restrict the ability of its subsidiaries to make dividends or other payments; guarantee indebtedness; engage in transactions with affiliates; create or designate unrestricted subsidiaries; and consolidate, merge or transfer all or substantially all of its assets and the assets of its subsidiaries on a consolidated basis. As of December 31, 2008, Holdings was in compliance with all

debt covenants related to the senior floating rate notes.

10% Senior Subordinated Notes

On February 24, 2005, Holdings issued 10% senior subordinated notes to WCAS Capital Partners IV, L.P., an investment fund affiliated with Welsh Carson, Rocco A. Ortenzio, Robert A. Ortenzio and certain other investors who are members of or affiliated with the Ortenzio family, for an aggregate purchase price of $150.0 million. The senior subordinated notes had preferred and common shares attached which were recorded at the estimated fair

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

market value on the date of issuance. These shares were recorded as a discount to the senior subordinated notes and are amortized using the interest method.

Maturities of Long-Term Debt and Notes Payable

Maturities of the Company s long-term debt for the years after 2008 are approximately as follows (in thousands):

2009	$ 9,046
2010	8,924
2011	632,627
2012	160,725
2013	
2014 and beyond	968,603

8. Stockholders Equity

Participating Preferred Stock

Holdings is authorized to issue 25,000,000 shares of participating preferred stock and had 22,163,323 shares and 22,148,453 shares of participating preferred stock outstanding at December 31, 2007 and 2008, respectively. Holdings repurchased 446 shares of participating preferred stock during the year ended December 31, 2007, and 14,870 shares of participating preferred stock during the year ended December 31, 2008. The participating preferred stock accrues dividends at an annual dividend rate of 5%, compounded quarterly on March 31, June 30, September 30 and December 31 of each year. Dividends earned during the year ended December 31, 2007 and the year ended December 31, 2008 amounted to $23.8 million and $25.0 million, respectively and were charged against retained earnings. Each share of participating preferred stock is entitled to one vote on all matters submitted to stockholders of Holdings. The participating preferred stock ranks senior to the common stock with respect to dividend rights and rights upon liquidation. The liquidation preference is equal to the original cost of a share of the participating preferred stock ($26.90 per share) plus all accrued and unpaid dividends thereon less the amount of any previously declared and paid special dividends.

Upon the redemption of the participating preferred stock occurring due to a change of control or the conversion and redemption of the participating preferred stock occurring due to a sale of common stock of Holdings through a public offering, each holder of participating preferred stock will receive cash equal to the original cost of a share of the participating preferred stock ($26.90 per share) plus all accrued and unpaid dividends thereon less the amount of any previously declared and paid special dividends and a number of shares of common stock equal to the number of participating preferred shares owned.

Common Stock

Holdings is authorized to issue 250,000,000 shares of $0.001 par value common stock and had 205,166,072 and 204,885,371 shares of common stock outstanding at December 31, 2007 and 2008, respectively. During the year ended December 31, 2007, Holdings repurchased 3,000 shares of common stock and issued 265,106 shares of

common stock of which 200,000 were restricted stock issuances. During the year ended December 31, 2008, Holdings issued 81,962 shares and repurchased 100,000 shares of common stock. In addition, during the year ended December 31, 2008, 262,663 shares of restricted common stock were forfeited.

Registration Statement

On July 25, 2008, Holdings filed a registration statement on Form S-1, which has been subsequently amended, to register shares of its common stock for sale to the public. Holdings intends to use the net proceeds it receives in

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the offering to repay term loans outstanding under the Company s senior secured credit facility, and any related prepayment costs, pursuant to the Company s mandatory prepayment obligation under the Company s senior secured credit facility in the amount of 50% of the net proceeds Holdings receives in the offering and to make payments under a long-term cash incentive plan. Any remaining net proceeds will be used for general corporate purposes consisting of the voluntary repayment of indebtedness under the Company s senior credit facility, the repurchase of a portion of Select s 75/8% Senior Subordinated Notes, the repurchase of a portion of the Holdings Notes and/or the repurchase of a portion of the 10% senior subordinated notes or general corporate purposes.

9. Long-term Incentive Compensation

On June 2, 2005, Holdings adopted a Long-Term Cash Incentive Plan (cash plan). The total number of units available under the cash plan for awards may not exceed 100,000. If any awards are terminated, forfeited or cancelled, units granted under such awards are available for award again under the cash plan. The purposes of the cash plan are to attract and retain key employees, motivate participating key employees to achieve the long-range goals of the Company, provide competitive incentive compensation opportunities and further align the interests of participating key employees with Holdings stockholders.

Payment of cash benefits is based upon (i) the value of the Company upon a change of control of Holdings or upon a qualified initial public offering of Holdings or (ii) a redemption of Holdings preferred stock or payment of special dividends on Holdings preferred stock. Until the occurrence of an event that would trigger the payment of cash on any outstanding units is deemed probable by the Company, no expense for any award is reflected in the Company s financial statements.

10. Stock Option and Restricted Stock Plans

The Company adopted SFAS No. 123R, Share-Based Payment on February 25, 2005. Holdings adopted the Select Medical Holdings Corporation 2005 Equity Incentive Plan (the Plan). The equity incentive plan provides for grants of restricted stock and stock options of Holdings. In addition, on August 10, 2005 the Board of Directors of Holdings authorized a director equity incentive plan (Director Plan) for non-employee directors. On November 8, 2005 the Board of Directors of Holdings formally approved the Director Plan and on August 12, 2009, the Board of Directors and stockholders of Holdings approved an amendment and restatement of the Director Plan that will become effective immediately prior to this offering. Following the effectiveness of such amendment and restatement, Holdings will be authorized to issue under the Director Plan options to purchase up to 250,000 shares of its common stock and restricted stock awards covering up to 500,000 shares of its common stock.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The options generally vest over five years and have an option term not to exceed ten years. The fair value of the options granted was estimated using the Black-Scholes option pricing model assuming an expected volatility of 34%, no dividend yield, an expected life of five years and a risk free rate of 4.5% in 2007 and expected volatility of 36%, no dividend yield, an expected life of five years and a risk free rate of 4.5% in 2008. The following is a summary of stock option grants under the Plan and Director Plan from January 1, 2006 through December 31, 2008:

	Number of Options Granted	Exercise Price	Fair Value of Common Stock
	(in thousands, except per share amounts)		
February 15, 2006	100	$ 1.00	$ 0.50
August 10, 2006	1,248	2.50	0.83
November 9, 2006	494	2.50	0.08
December 11, 2006	100	2.50	0.08
February 13, 2007	56	2.50	0.08
May 9, 2007	327	2.50	0.08
August 15, 2007	760	2.50	0.98
November 14, 2007	106	2.50	0.98
February 13, 2008	200	2.50	0.98
May 13, 2008	28	2.50	0.98
August 20, 2008	404	3.00	3.00
November 13, 2008	20	3.00	3.00

Stock option transactions and other information related to the Plan are as follows:

	Price per Share	Shares	Weighted Average Exercise Price
	(in thousands, except per share amounts)		
Balance, January 1, 2007	$ 1.00 - 2.50	3,773	$ 1.71
Granted	2.50	1,219	2.50
Exercised	1.00 - 2.50	(65)	1.02
Canceled	1.00 - 2.50	(387)	2.03
Balance, December 31, 2007	1.00 - 2.50	4,540	1.91
Granted	2.50 - 3.00	602	2.81
Exercised	1.00 - 2.50	(82)	1.10
Canceled	1.00 - 3.00	(277)	2.29
Balance, December 31, 2008	$ 1.00 - 3.00	4,783	$ 2.01

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Additional information with respect to the outstanding options as of December 31, 2008 for the Plan is as follows:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable
	(in thousands, except per share amounts)		
$ 1.00	1,678	6.21	987
2.50	2,736	8.14	838
3.00	369	9.63	

Transactions and other information related to the Director s Plan are as follows:

	Price per Share	Shares	Weighted Average Exercise Price
	(in thousands, except per share amounts)		
Balance, January 1, 2007	$ 1.00 - 2.50	90	$ 1.50
Granted	2.50	30	2.50
Balance, December 31, 2007	1.00 - 2.50	120	1.75
Granted	3.00	50	3.00
Balance, December 31, 2008	$ 1.00 - 3.00	170	$ 2.12

Additional information with respect to the outstanding options as of December 31, 2008 for the Director s Plan is as follows:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable
	(in thousands, except per share amounts)		
$ 1.00	60	6.61	36
2.50	60	8.24	18
3.00	50	9.73	

Holdings granted 200,000 shares of common stock of Holdings as restricted stock awards during the year ended December 31, 2007. The restricted stock awards range in value from $0.08 to $0.50 per share and generally vest over five years. The fair value of the restricted stock awards were determined by estimating the per share fair value of

common equity on a minority, non-marketable basis utilizing a version of the income approach referred to as The Probability-Weighted Expected Return Method. This method estimates the value of common stock based upon an analysis of future values assuming an initial public offering, sale and continued operation as a viable private enterprise. The following is a summary of restricted stock issuances from January 1, 2006 through December 31, 2008:

	Number of Shares Issued	**Fair Value of Common Stock**
February 15, 2006	100,000	$0.50
December 11, 2006	100,000	0.08
February 13, 2007	200,000	0.08

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock compensation expense for each of the next five years, based on restricted stock awards granted as of December 31, 2008, is estimated to be as follows:

	2009	2010	2011	2012	2013
	(in thousands)				
Stock compensation expense	$ 1,082	$ 181	$ 3	$ 0	$ 0

The Company recognized the following stock compensation expense related to restricted stock and stock option awards:

	For the Year Ended December 31,		
	2006	2007	2008
	(in thousands)		
Stock compensation expense:			
Included in general and administrative	$ 3,551	$ 3,555	$ 1,953
Included in cost of services	231	191	140
Total	$ 3,782	$ 3,746	$ 2,093

11. Income Taxes

Significant components of the Company s tax provision from continuing operations for the years ended December 31, 2006, 2007, and 2008 are as follows:

	For the Year Ended December 31,		
	2006	2007	2008
	(in thousands)		
Current:			
Federal	$ 24,706	$ 11,004	$ (262)
State and local	5,488	5,235	4,569
Total current	30,194	16,239	4,307
Deferred	13,327	2,460	21,756
Total income tax provision	$ 43,521	$ 18,699	$ 26,063

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The differences between the expected income tax provision from continuing operations and income taxes computed at the federal statutory rate of 35% were as follows:

	For the Year Ended December 31,		
	2006	2007	2008
Expected federal tax rate	35.0%	35.0%	35.0%
State and local taxes, net of federal benefit	3.0	2.5	6.0
Other permanent differences	0.9	2.0	2.2
Valuation allowance	2.7	(0.7)	8.6
Tax loss on sale of subsidiaries	(6.9)	(5.7)	(0.7)
Uncertain tax positions		2.1	3.2
Other	(0.1)	(0.7)	(0.6)
Total	34.6%	34.5%	53.7%

In the above table, certain reclassifications have been made to 2007 components of the effective tax rate reconciliation to conform to the 2008 presentation.

A summary of deferred tax assets and liabilities is as follows:

	December 31,	
	2007	2008
	(in thousands)	
Deferred tax assets current		
Allowance for doubtful accounts	$ 7,440	$ 8,535
Compensation and benefit related accruals	26,746	20,371
Malpractice insurance	10,867	11,856
Restructuring reserve	6,216	3,239
Net operating loss carry forwards	396	12,833
Interest rate swap		10,155
Other accruals, net	2,503	135
Net deferred tax asset current	54,168	67,124
Deferred tax assets (liabilities) non-current		
Expenses not currently deductible for tax	101	101
Excess capital loss carry forwards	2,619	6,424
Net operating loss carry forwards	24,693	27,464

Restricted stock	(1,426)	(567)
Interest rate swaps	3,708	5,169
Depreciation and amortization	(44,214)	(67,179)
Other	3,134	3,480
Net deferred tax liability non-current	(11,385)	(25,108)
Net deferred tax asset before valuation allowance	42,783	42,016
Valuation allowance	(16,761)	(23,009)
Net deferred tax asset	$ 26,022	$ 19,007

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The valuation allowance is primarily attributable to the uncertainty regarding the realization of state net operating losses, excess federal capital loss carry forwards and other net deferred tax assets of loss entities. The net deferred tax assets at December 31, 2008 of approximately $19.0 million consist of items which have been recognized for financial reporting purposes, but will reduce tax on returns to be filed in the future and include the use of net operating loss carryforwards. The Company has performed the required assessment of positive and negative evidence regarding the realization of the net deferred tax assets in accordance with SFAS No. 109, Accounting for Income Taxes. This assessment included a review of legal entities with three years of cumulative losses, estimates of projected future taxable income and the impact of tax-planning strategies that management plans to implement. Although realization is not assured, based on the Company s assessment, it has concluded that it is more likely than not that such assets, net of the existing valuation allowance, will be realized.

Federal net operating loss carry forwards totaling $36.7 million will begin to expire in 2021 and thereafter. As a result of the acquisition of Kessler Rehabilitation Corporation and SemperCare, Inc., the Company is subject to the provisions of Section 382 of the Internal Revenue Code which provide for annual limitations on the deductibility of acquired net operating losses and certain tax deductions. These limitations apply until the earlier of utilization or expiration of the net operating losses. Additionally, if certain substantial changes in the Company s ownership should occur, there would be an annual limitation on the amount of the carryforwards that can be utilized.

The total state net operating losses are approximately $554.0 million. State net operating loss carry forwards expire and have a respective valuation allowance as follows (in thousands):

	State Net Operating Losses	Valuation Allowance
2009	$ 8,773	$ 8,773
2010	7,902	7,565
2011	6,647	6,502
2012	8,913	8,882
Thereafter through 2028	521,560	364,537

Reserves for Uncertain Tax Positions:

The Company adopted FIN No. 48 on January 1, 2007. Upon adoption, the Company recognized a $6.0 million increase to reserves for uncertain tax positions and a $4.1 million increase to deferred tax assets with a net adjustment to the beginning balance of retained earnings of $1.9 million. Including the cumulative effect of the increases in reserves and deferred tax assets, at the beginning of 2007, the Company had approximately $18.3 million of unrecognized tax benefits.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. The Company was subject to Canadian income tax prior to the disposition of its Canadian operations on March 1, 2006. Significant judgment is required in evaluating the Company s tax positions and determining its provision for income taxes. During the ordinary course of business, there are many transactions and calculations for

which the ultimate tax determination is uncertain. The Company establishes reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. These reserves are established when it is believed that certain positions might be challenged despite the Company s belief that its tax return positions are fully supportable. The Company adjusts these reserves in light of changing facts and circumstances, such as the outcome of a tax audit. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate. Accruals for uncertain tax positions are provided for in accordance with the requirements of FIN No. 48.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The reconciliation of the Company s unrecognized tax benefits is as follows (in thousands):

Gross tax contingencies January 1, 2007	$ 21,305
Reductions for tax positions taken in prior years	(2,249)
Additions for current period tax positions taken	2,357
Gross tax contingencies December 31, 2007	21,413
Reductions for tax positions taken in prior periods	(839)
Additions for current period tax positions taken	1,918
Gross tax contingencies December 31, 2008	$ 22,492

As of December 31, 2007 and 2008, the Company had $21.4 million and $22.5 million of unrecognized tax benefits, respectively, all of which, if fully recognized, would affect the Company s effective income tax rate.

As of December 31, 2008, changes to the Company s gross unrecognized tax benefits that are reasonably possible in the next 12 months are not material. The Company s policy is to include interest related to income taxes in income tax expense. As of December 31, 2008, the Company had accrued interest related to income taxes of $0.8 million, net of federal income tax benefits, on the balance sheet. Interest recognized for the year ended December 31, 2008 was $0.3 million net of federal income tax benefits.

The Company has substantially concluded all U.S. federal income tax matters for years through 2004. Substantially all material state, local and foreign income tax matters have been concluded for years through 2001. The federal income tax return for 2005 is currently under examination.

12. Retirement Savings Plan

The Company sponsors a defined contribution retirement savings plan for substantially all of its employees. Employees who are not classified as HCE s (highly compensated employees) may contribute up to 30% of their salary; HCE s may contribute up to 6% of their salary. The Plan provides a discretionary company match which is determined annually. Currently, the Company matches 50% of the first 6% of compensation employees contribute to the plan. The employees vest in the employer contributions over a three-year period beginning on the employee s hire date. The expense incurred by the Company related to this plan was $9.0 million, $5.7 million and $11.7 million during the years ended December 31, 2006, 2007 and 2008, respectively.

13. Segment Information

SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, establishes standards for reporting information about operating segments and related disclosures about products and services, geographic areas and major customers.

The Company s reportable segments consist of (i) specialty hospitals and (ii) outpatient rehabilitation. All other represents amounts associated with corporate activities and non-healthcare related services. The outpatient rehabilitation reportable segment has two operating segments: outpatient rehabilitation clinics and contract therapy. These operating segments are aggregated for reporting purposes as they have common economic characteristics and provide a similar service to a similar patient base. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance of the segments based on Adjusted EBITDA. Adjusted EBITDA is defined as net income before interest, income taxes, stock compensation expense, depreciation and amortization, income from discontinued operations, gain on early retirement of debt, other income (expense) and minority interest.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes selected financial data for the Company s reportable segments:

	Year Ended December 31, 2006			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net revenue	$ 1,378,543	$ 470,339	$ 2,616	$ 1,851,498
Adjusted EBITDA	283,270	64,823	(39,769)	308,324
Total assets	1,742,803	258,773	180,948	2,182,524
Capital expenditures	146,291	6,527	2,278	155,096

	Year Ended December 31, 2007			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net revenue	$ 1,386,410	$ 603,413	$ 1,843	$ 1,991,666
Adjusted EBITDA	217,175	75,437	(37,684)	254,928
Total assets(1)	1,882,476	513,397	99,173	2,495,046
Capital expenditures	146,901	14,737	4,436	166,074

	Year Ended December 31, 2008			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net revenue	$ 1,488,412	$ 664,760	$ 190	$ 2,153,362
Adjusted EBITDA	236,388	77,279	(43,380)	270,287
Total assets(1):	1,910,402	504,869	164,198	2,579,469
Capital expenditures	40,069	13,271	3,164	56,504

(1) The specialty hospital segment includes $14.6 million and $12.5 million in real estate assets held for sale on December 31, 2007 and 2008, respectively.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A reconciliation of Adjusted EBITDA to income from continuing operations before income taxes is as follows:

	Year Ended December 31, 2006			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	
	(In thousands)			
Adjusted EBITDA	$ 283,270	$ 64,823	$ (39,769)	
Depreciation and amortization	(30,731)	(12,964)	(2,973)	
Stock compensation expense			(3,782)	
Income (loss) from operations	$ 252,539	$ 51,859	$ (46,524)	$ 257,874
Interest expense, net				(130,538)
Income from continuing operations before income taxes				$ 127,336

	Year Ended December 31, 2007			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	
	(in thousands)			
Adjusted EBITDA	$ 217,175	$ 75,437	$ (37,684)	
Depreciation and amortization	(37,085)	(17,458)	(2,754)	
Stock compensation expense			(3,746)	
Income (loss) from operations	$ 180,090	$ 57,979	$ (44,184)	$ 193,885
Other expense				(167)
Interest expense, net				(138,052)
Income from continuing operations before income taxes				$ 55,666

	Year Ended December 31, 2008		
	Specialty Hospitals	Outpatient Rehabilitation	All Other
	(in thousands)		
Adjusted EBITDA	$ 236,388	$ 77,279	$ (43,380)

Depreciation and amortization	(43,938)	(24,315)	(3,533)	
Stock compensation expense			(2,093)	
Income (loss) from operations	$ 192,450	$ 52,964	$ (49,006)	$ 196,408
Gain on early retirement of debt				912
Interest expense, net				(145,423)
Income from continuing operations before income taxes				$ 51,897

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Income (Loss) per Share

The Company applies the two-class method for calculating and presenting income (loss) per common share. As noted in SFAS No. 128, Earnings per Share (as amended), the two-class method is an earnings (loss) allocation formula that determines earnings (losses) per share for each class of stock participation rights in undistributed earnings (losses). Effective January 1, 2009 the Company adopted FASB Staff Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities (FSP EITF 03-6-1). FSP EITF 03-6-1 clarified that share based payment awards that have not yet vested do meet the definition of a participating security provided the right to receive the dividend is non-forfeitable and non-contingent. Participating securities are defined as securities that participate in dividends with common stock according to a predetermined formula. These participating securities should be included in the computation of basic earnings per share under the two class method. In applying FSP EITF 03-6-1 the Company has concluded that its non-vested restricted stock awards meet the definition of a participating security and should be included in the Company s computation of basic earnings per share. The earnings per share calculations for the years ended December 31, 2006, 2007 and 2008 have been revised to conform to the presentation prescribed in FSP EITF 03-6-1. The adoption of FSP EITF 03-6-1 had no impact on earnings per share for the year ended December 31, 2007 and 2008. As a result of this accounting change, basic and diluted income per common share for the year ended December 31, 2006 was effected as follows:

	As Originally Reported	As Adjusted For FSP EITF 03-6-1
Basic income per common share:		
Income from continuing operations	$ 0.30	$ 0.26
Discontinued operations, net of tax	0.06	0.06
Net income per common share	$ 0.36	$ 0.32
Diluted income per common share:		
Income from continuing operations	$ 0.28	$ 0.26
Discontinued operations, net of tax	0.06	0.06
Net income per common share	$ 0.32	$ 0.32

Under the two class method:

(a) Income from continuing operations is reduced by the contractual amount of dividends in the current period for each class of stock.

(b) The remaining income (loss) is allocated to common stock, unvested restricted stock and participating preferred stock to the extent that each security may share in income (loss), as if all of the earnings (losses) for the period had been distributed. The total income (loss) allocated to each security is determined by

adding together the amount allocated for dividends and the amount allocated for participation features.

(c) The income (loss) allocated to common stock is then divided by the weighted average number of outstanding shares to which the earnings are allocated to determine the income (loss) per share for common stock.

In applying the two-class method, the Company determined that undistributed earnings should be allocated equally on a per share basis between the common stock, unvested restricted stock and participating preferred stock due to the equal participation rights of the common stock, unvested restricted stock and participating preferred stock (i.e., the voting conversion rights) and losses should be allocated equally on a per share basis between common stock and participating preferred stock.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table sets forth for the periods indicated the calculation of income (loss) per share in the Company s Consolidated Statement of Operations and the differences between basic weighted average shares outstanding and diluted weighted average shares outstanding used to compute basic and diluted earnings per share, respectively:

	For the Year Ended December 31,		
	2006	2007	2008
	(in thousands, except per share amounts)		
Numerator:			
Net income attributable to Select Medical Holdings Corporation	$ 94,879	$ 35,430	$ 22,441
Less: Income from discontinued operations	12,478		
Income from continuing operations	$ 82,401	$ 35,430	$ 22,441
Less: Preferred dividends	22,663	23,807	24,972
Less: Earnings (losses) allocated to unvested restricted stockholders	6,615	758	
Less: Earnings (losses) allocated to preferred stockholders	5,819	1,133	(254)
Net income (loss) available to common stockholders continuing operations	$ 47,304	$ 9,732	$ (2,277)
Numerator:			
Income from discontinued operations	$ 12,478	$	$
Less: Earnings allocated to unvested restricted stockholders	1,382		
Less: Earnings allocated to preferred stockholders	1,215		
Net income available to common stockholders discontinued operations	$ 9,881	$	$
Denominator:			
Weighted average shares basic and diluted	180,183	190,286	198,554
Basic income (loss) per common share:			
Income (loss) from continuing operations	$ 0.26	$ 0.05	$ (0.01)
Discontinued operations, net of tax	0.06		
Net income (loss) per common share	$ 0.32	$ 0.05	$ (0.01)
Diluted income (loss) per common share:			
Income (loss) from continuing operations	$ 0.26	$ 0.05	$ (0.01)
Discontinued operations, net of tax	0.06		
Diluted income (loss) per common share	$ 0.32	$ 0.05	$ (0.01)

The following amounts are shown here for informational and comparative purposes only since their inclusion would be anti-dilutive:

	For the Year Ended December 31,		
	2006	**2007**	**2008**
	(in thousands)		
Stock options	2,589	4,005	3,801
Restricted stock			5,278

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The participating preferred stock is convertible upon a qualifying public offering, as defined in Holdings amended and restated certificate of incorporation. No conversion has been assumed in the computation of earnings per share. See Note 8 Stockholders Equity for further information on the terms of Holding s preferred stock.

15. Fair Value of Financial Instruments

Financial instruments include cash and cash equivalents, notes payable and long-term debt. The carrying amount of cash and cash equivalents approximates fair value because of the short-term maturity of these instruments.

The Company is exposed to the impact of interest rate changes. The Company s objective is to manage the impact of the interest rate changes on earnings and cash flows. On June 13, 2005, Select entered into an interest rate swap agreement to hedge Select s interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was August 22, 2005. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $200.0 million, and the underlying variable rate debt is associated with Select s senior secured credit facility. The variable interest rate of the debt was 4.2% and the fixed rate of the swap was 6.3% at December 31, 2008. The swap is for a period of five years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

On September 19, 2005, Select entered into two additional interest rate swap agreements to hedge Holdings interest rate risk for its senior floating rate notes. The effective date of the swap transactions was September 29, 2005. The swaps are designated as cash flow hedges of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swaps is $175.0 million, and the underlying variable rate debt is associated with Holdings $175.0 million senior floating rate notes due 2015. The variable interest rate of the debt was 8.8% and the fixed rate of the swaps was 10.2% at December 31, 2008. The swaps are for a period of four years, with semi-annual resets on March 15 and September 15 of each year.

On March 8, 2007, Select entered into an additional interest rate swap agreement to hedge Select s interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was May 22, 2007. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $200.0 million, and the underlying variable rate debt is associated with Select s senior secured credit facility. The variable interest rate of the debt was 4.2% and the fixed rate of the swap was 6.8% at December 31, 2008. The swap is for a period of three years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

On November 16, 2007, Select entered into an additional interest rate swap agreement to hedge Select s interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was November 23, 2007. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $100.0 million, and the underlying variable rate debt is associated with Select s senior secured credit facility. The variable interest rate of the debt was 4.2% and the fixed rate of the swap was 6.3% at December 31, 2008. The swap is for a period of three years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

The interest rate swaps have been designated as hedges and qualify under the provision of SFAS No. 133 as effective hedges. The interest rate swaps are reflected at fair value in the consolidated balance sheet and the related loss of

$10.5 million, net of tax, and the loss of $7.6 million, net of tax, was recorded in stockholders equity as a component of other comprehensive income (loss) for the years ended December 31, 2007 and 2008, respectively. The Company will test for ineffectiveness whenever financial statements are issued or at least every three months using the Hypothetical Derivative Method.

Borrowings under Select s senior secured credit facility which are not subject to the swaps have variable rates that reflect currently available terms and conditions for similar debt. The carrying amount of this debt was

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$783.3 million and $806.5 million at December 31, 2007 and 2008, respectively. The fair value of Select s senior secured credit facility was $732.2 million and $523.3 million at December 31, 2007 and 2008, respectively.

At December 31, 2007 the carrying value of the 75/8% Senior Subordinated Notes was $660.0 million and the estimated fair value was $567.6 million and at December 31, 2008 the carrying value was $658.0 million and the estimated fair value was $335.6 million.

At December 31, 2007 the carrying value of the senior floating rate notes was $175.0 million and the estimated fair value was $152.3 million and at December 31, 2008 the carrying value was $175.0 million and the estimated fair value was $89.3 million.

16. Related Party Transactions

The Company is party to various rental and other agreements with companies owned by related parties affiliated through common ownership or management. The Company made rental and other payments aggregating $2.3 million during the years ended December 31, 2006 and 2007 and $3.3 million during the year ended December 31, 2008 to the affiliated companies.

As of December 31, 2008, future rental commitments under outstanding agreements with the affiliated companies are approximately as follows (in thousands):

2009	$ 2,978
2010	2,996
2011	2,998
2012	3,085
2013	3,200
Thereafter	31,168
	$ 46,425

17. Commitments and Contingencies

Leases

The Company leases facilities and equipment from unrelated parties under operating leases. Minimum future lease obligations on long-term non-cancelable operating leases in effect at December 31, 2008 are approximately as follows (in thousands):

2009	$ 108,438
2010	81,065
2011	59,341

2012	41,373
2013	29,438
Thereafter	171,321
	$ 490,976

Total rent expense for operating leases, including cancelable leases, for the years ended December 31, 2006, 2007 and 2008 was $118.4 million, $131.9 million and $139.3 million, respectively.

Facility rent expense for the years ended December 31, 2006, 2007 and 2008 was $84.0 million, $98.5 million and $110.2 million, respectively.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Construction Commitments

At December 31, 2008, the Company has outstanding commitments under construction contracts related to new construction, improvements and renovations at the Company s long term acute care properties and inpatient rehabilitation facilities totaling approximately $15.8 million.

Other

In March 2000, the Company entered into three-year employment agreements with three of its executive officers. Under these agreements, the three executive officers currently receive a combined total annual salary of $2.4 million subject to adjustment by the Company s Board of Directors. The employment agreements also contain a change in control provision and provides that the three executive officers will receive long-term disability insurance. At the end of each 12-month period beginning March 1, 2000, the term of each employment agreement automatically extends for an additional year unless one of the executives or the Company gives written notice to the other not less than three months prior to the end of that 12-month period that they do not want the term of the employment agreement to continue.

The Company has entered into change in control agreements with six other members of senior management.

A subsidiary of the Company has entered into a naming, promotional and sponsorship agreement with an NFL team for the team s headquarters complex that requires a payment of $2.6 million in 2009. Each successive annual payment increases by 2.3% through 2025. The naming, promotional and sponsorship agreement is in effect until 2025.

Litigation

On August 24, 2004, Clifford C. Marsden and Ming Xu filed a purported class action complaint in the United States District Court for the Eastern District of Pennsylvania on behalf of the public stockholders of Select against Martin F. Jackson, Robert A. Ortenzio, Rocco A. Ortenzio, Patricia A. Rice and Select. The complaint as later amended alleged, among other things, failure to disclose adverse information regarding a potential regulatory change affecting reimbursement for Select s services applicable to long term acute care hospitals operated as hospitals within hospitals. On October 25, 2007, the Court certified a class of investors who purchased Select stock between July 29, 2003 and May 11, 2004, inclusive. The Court also appointed class representatives and class counsel. On July 3, 2008, the parties reached a settlement in principle. The parties signed the settlement agreement on November 5, 2008 and it was filed with the Court on November 14, 2008. On December 19, 2008, the Court granted preliminary approval of the settlement. The settlement requires defendants to pay $5.0 million, which has been paid into a settlement fund by the Company s insurer. On April 14, 2009, the Court granted final approval of the settlement.

To cover claims arising out of the operations of the Company s specialty hospitals and outpatient rehabilitation facilities, the Company maintains professional malpractice liability insurance and general liability insurance. The Company also maintains umbrella liability insurance covering claims which, due to their nature or amount, are not covered by or not fully covered by the Company s other insurance policies. These insurance policies also do not generally cover punitive damages and are subject to various deductibles and policy limits. Significant legal actions as well as the cost and possible lack of available insurance could subject the Company to substantial uninsured liabilities.

The Company is subject to legal proceedings and claims that arise in the ordinary course of business, which include malpractice claims covered under insurance policies, subject to self-insured retention of $2.0 million per medical incident for professional liability claims and $2.0 million per occurrence for general liability claims. In the Company s opinion, the outcome of these actions will not have a material adverse effect on its financial position or results of operations.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Health care providers are subject to lawsuits under the qui tam provisions of the federal False Claims Act. Qui tam lawsuits typically remain under seal (hence, usually unknown to the defendant) for some time while the government decides whether or not to intervene on behalf of a private qui tam plaintiff (known as a relator) and take the lead in the litigation. These lawsuits can involve significant monetary damages and penalties and award bounties to private plaintiffs who successfully bring the suits. The Company has been a defendant in these cases in the past, and may be named as a defendant in similar cases from time to time in the future.

18. Supplemental Disclosures of Cash Flow Information

Non-cash investing and financing activities are comprised of the following for the years ended December 31, 2006, 2007 and 2008:

	For the Year Ended December 31,		
	2006	2007	2008
	(in thousands)		
Notes issued with acquisitions (Note 2)	$	$	$ 1,001
Liabilities assumed with acquisitions (Note 2)		36,458	253
Notes recorded related to sale of business (Note 3)	8,436	2,616	

19. Selected Quarterly Financial Data (Unaudited)

The table below sets forth selected unaudited financial data for each quarter of the last two years.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)			
Year ended December 31, 2007				
Net revenues	$ 466,829	$ 506,484	$ 500,385	$ 517,968
Income from operations	60,325	60,576	31,292	41,692
Net income (loss) attributable to Select Medical Holdings Corporation	$ 17,471	$ 14,315	$ (3,106)	$ 6,750
Net income (loss) per common share[(1)]				
Basic	$ 0.05	$ 0.04	$ (0.04)	$ 0.00
Diluted	$ 0.05	$ 0.04	$ (0.04)	$ 0.00

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
		(in thousands)		
Year ended December 31, 2008				
Net revenues	$ 548,278	$ 538,806	$ 519,179	$ 547,099
Income from operations	54,344	48,421	36,158	57,485
Net income (loss) attributable to Select Medical Holdings Corporation	$ 8,700	$ 5,753	$ (823)	$ 8,811
Net income (loss) per common share(1):				
Basic	$ 0.01	$ 0.00	$ (0.03)	$ 0.01
Diluted	$ 0.01	$ 0.00	$ (0.03)	$ 0.01

(1) Adjusted for the adoption of FASB Staff Position EITF 03-6-1 Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 14 for additional information.

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The following Financial Statement Schedule along with the report thereon of PricewaterhouseCoopers LLP dated March 23, 2009, except with respect to their opinion on the consolidated financial statements insofar as it relates to the effects of the change in accounting for non-controlling interests (Note 1) and for unvested restricted stock in the calculation of earnings per share (Note 14), as to which the date is June 18, 2009, on page F-2 should be read in conjunction with the consolidated financial statements. Financial Statement Schedules not included in this filing have been omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.

Schedule II Valuation and Qualifying Accounts
(in thousands)

Description	Balance at Beginning of Year	Charged to Cost and Expenses	Acquisitions[(A)]	Deductions[(B)]	Balance at End of Year
Year ended December 31, 2008 allowance for doubtful accounts,	$ 55,856	$ 47,804	$ 183	$ (46,791)	$ 57,052
Year ended December 31, 2007 allowance for doubtful accounts	$ 55,306	$ 37,572	$ 9,061	$ (46,083)	$ 55,856
Year ended December 31, 2006 allowance for doubtful accounts	$ 74,891	$ 18,810	$	$ (38,395)	$ 55,306
Year ended December 31, 2008 income tax valuation allowance	$ 16,761	$ 6,355	$	$ (108)	$ 23,008
Year ended December 31, 2007 income tax valuation allowance	$ 14,428	$ 2,507	$	$ (174)	$ 16,761
Year ended December 31, 2006 income tax valuation allowance	$ 11,961	$ 3,485	$	$ (1,018)	$ 14,428

(A) Represents opening balance sheet reserves resulting from purchase accounting entries.

(B) Allowance for doubtful accounts deductions represent write-offs against the reserve for 2006, 2007 and 2008. Income tax valuation allowance deductions primarily represent the disposition of certain subsidiaries.

SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED BALANCE SHEETS

	December 31, 2008[(1)]	June 30, 2009 (unaudited)	Pro Forma Preferred Stock and Equity at June 30, 2009 (unaudited)
	(in thousands, except share and per share amounts)		
ASSETS			
Current Assets:			
Cash and cash equivalents	$ 64,260	$ 27,689	
Accounts receivable, net of allowance for doubtful accounts of $57,052 and $52,685 in 2008 and 2009, respectively	312,418	339,615	
Current deferred tax asset	61,925	52,270	
Prepaid income taxes	7,362		
Other current assets	20,897	21,776	
Total Current Assets	466,862	441,350	
Property and equipment, net	471,065	460,420	
Goodwill	1,506,661	1,506,661	
Other identifiable intangibles	74,078	69,663	
Assets held for sale	12,542	11,342	
Other assets	48,261	43,246	
Total Assets	$ 2,579,469	$ 2,532,682	
LIABILITIES AND EQUITY			
Current Liabilities:			
Bank overdrafts	$ 21,130	$ 16,472	
Current portion of long-term debt and notes payable	9,046	10,670	
Accounts payable	72,496	68,777	
Accrued payroll	66,380	57,832	
Accrued vacation	37,109	40,380	
Accrued interest	37,032	35,500	
Accrued restructuring	8,108	6,061	
Accrued other	91,482	95,893	
Income taxes payable		441	
Due to third party payors	5,709	5,493	
Total Current Liabilities	348,492	337,519	
Long-term debt, net of current portion	1,770,879	1,686,464	
Non-current deferred tax liability	42,918	51,967	

Other non-current liabilities	67,709	62,248	
Total Liabilities	2,229,998	2,138,198	
Commitments and Contingencies			
Preferred stock Authorized shares (liquidation preference is $515,872 and $528,742 in 2008 and 2009, respectively)	515,872	528,742	$
Stockholders Equity:			
Common stock $0.001 par value, 250,000,000 shares authorized, 204,885,000 shares and 204,841,000 shares issued and outstanding in 2008 and 2009, respectively	205	205	125
Capital in excess of par	(289,382)	(288,844)	254,817
Retained earnings	128,185	160,103	145,264
Accumulated other comprehensive loss	(13,212)	(13,123)	(13,123)
Total Select Medical Holdings Corporation Stockholders Equity	(174,204)	(141,659)	387,083
Non-controlling interest	7,803	7,401	7,401
Total Equity	(166,401)	(134,258)	394,484
Total Liabilities and Equity	$ 2,579,469	$ 2,532,682	$ 2,532,682

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 2, Accounting Policies Recent Accounting Pronouncements, for additional information.

The accompanying notes are an integral part of this statement.

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SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2008[1][2]	2009	2008[1][2]	2009
	(unaudited) (in thousands, except per share amounts)			
Net operating revenues	$ 538,806	$ 559,535	$ 1,087,084	$ 1,120,707
Costs and expenses:				
Cost of services	449,356	453,011	901,627	904,405
General and administrative	12,654	12,885	24,305	25,660
Bad debt expense	10,445	10,312	23,060	21,958
Depreciation and amortization	17,930	17,939	35,327	35,670
Total costs and expenses	490,385	494,147	984,319	987,693
Income from operations	48,421	65,388	102,765	133,014
Other income and expense:				
Gain on early retirement of debt		3,562		15,316
Interest income	56	28	182	80
Interest expense	(36,531)	(33,658)	(73,450)	(68,330)
Income from operations before income taxes	11,946	35,320	29,497	80,080
Income tax expense	5,431	15,137	13,973	33,880
Net income	6,515	20,183	15,524	46,200
Less: Net income attributable to non-controlling interests	762	391	1,071	1,412
Net income attributable to Select Medical Holdings Corporation	5,753	19,792	14,453	44,788
Less: Preferred dividends	6,195	6,508	12,279	12,870
Net income (loss) available to common stockholders	$ (442)	$ 13,284	$ 2,174	$ 31,918
Income per common share:				
Basic	$ (0.00)	$ 0.06	$ 0.01	$ 0.14
Diluted	$ (0.00)	$ 0.06	$ 0.01	$ 0.14
Unaudited pro forma net income per common share:				
Basic		$ 0.14		$ 0.30
Diluted		$ 0.14		$ 0.30

(1)

Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 2, Accounting Policies Recent Accounting Pronouncements, for additional information.

(2) Adjusted for the adoption of FASB Staff Position EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 8 for additional information.

The accompanying notes are an integral part of this statement.

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SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS   EQUITY AND COMPREHENSIVE INCOME

(unaudited)
(in thousands)

	Select Medical Holdings Corporation Stockholders							
	Total	Comprehensive Income	Common Stock Issued	Common Stock Par Value	Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non-controlling Interests
Balance at December 31, 2008(1)	$ (166,401)		204,885	$ 205	$ (289,382)	$ 128,185	$ (13,212)	$ 7,803
Net income	46,200	$ 46,200				44,788		1,412
Unrealized loss on interest rate swap, net of tax	89	89					89	
Total comprehensive income	$ 46,289	$ 46,289						
Issuance and vesting of restricted stock	530				530			
Exercise of stock options	24		10		24			
Stock option expense	64				64			
Repurchase of common shares	(80)		(54)		(80)			
Distributions to non-controlling interests	(1,814)							(1,814)
Accretion of dividends on preferred stock	(12,870)					(12,870)		
Balance at June 30, 2009	$ (134,258)		204,841	$ 205	$ (288,844)	$ 160,103	$ (13,123)	$ 7,401

(1)

Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 2, Accounting Policies Recent Accounting Pronouncements, for additional information.

The accompanying notes are an integral part of this statement.

SELECT MEDICAL HOLDINGS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Six Months Ended June 30,			
	2008[1]		2009	
	(unaudited) (in thousands)			
Operating activities				
Net income	$	15,524	$	46,200
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation and amortization		35,327		35,670
Provision for bad debts		23,060		21,958
Gain on early retirement of debt				(15,316)
Loss from disposal of assets		387		117
Non-cash stock compensation expense		1,192		594
Amortization of debt discount		724		815
Changes in operating assets and liabilities, net of effects from acquisition of businesses:				
Accounts receivable		(87,265)		(49,155)
Other current assets		4,682		(667)
Other assets		8,040		4,242
Accounts payable		(2,449)		(3,693)
Due to third-party payors		(9,931)		(216)
Accrued expenses		(564)		(5,927)
Income and deferred taxes		10,280		22,613
Net cash provided by (used in) operating activities		(993)		57,235
Investing activities				
Purchases of property and equipment		(26,107)		(20,981)
Proceeds from sale of property				1,341
Acquisition of businesses, net of cash acquired		(4,246)		
Net cash used in investing activities		(30,353)		(19,640)
Financing activities				
Borrowings on revolving credit facility		312,000		138,000
Payments on revolving credit facility		(262,000)		(173,000)
Payment on credit facility term loan		(4,582)		(3,400)
Repurchase of 75/8% senior subordinated notes				(30,114)
Borrowings of other debt				5,184
Principal payments on seller and other debt		(2,622)		(3,891)
Payment of initial public offering costs				(417)
Repurchase of common and preferred stock		(612)		(80)

Exercise of stock options		26		24
Repayment of bank overdrafts		(6,888)		(4,658)
Distributions to non-controlling interests		(971)		(1,814)
Net cash provided by (used in) financing activities		34,351		(74,166)
Net increase (decrease) in cash and cash equivalents		3,005		(36,571)
Cash and cash equivalents at beginning of period		4,529		64,260
Cash and cash equivalents at end of period	$	7,534	$	27,689
Supplemental Cash Flow Information				
Cash paid for interest	$	68,312	$	64,710
Cash paid for taxes	$	3,700	$	11,090

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 2, Accounting Policies Recent Accounting Pronouncements, for additional information.

The accompanying notes are an integral part of this statement.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Basis of Presentation

On February 24, 2005, Select Medical Corporation (Select) merged with a subsidiary of Select Medical Holdings Corporation (Holdings), formerly known as EGL Holding Company, and became a wholly-owned subsidiary of Holdings (Merger). Holdings and Select and their subsidiaries are collectively referred to as the Company. The consolidated financial statements of Holdings include the accounts of its wholly-owned subsidiary Select. Holdings conducts substantially all of its business through Select and its subsidiaries.

The unaudited condensed consolidated financial statements of the Company as of June 30, 2009 and for the three and six month periods ended June 30, 2008 and 2009 have been prepared in accordance with generally accepted accounting principles. In the opinion of management, such information contains all adjustments necessary for a fair statement of the financial position, results and cash flow for such periods. All significant intercompany transactions and balances have been eliminated. The results of operations for the three and six months ended June 30, 2009 are not necessarily indicative of the results to be expected for the full fiscal year ending December 31, 2009.

Certain information and disclosures normally included in the notes to consolidated financial statements have been condensed or omitted consistent with the rules and regulations of the Securities and Exchange Commission (the SEC), although the Company believes the disclosure is adequate to make the information presented not misleading. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2008 available on the Company s website: www.selectmedicalcorp.com under the Investor Relations section of the website. Please note that none of the information on the Company s website is incorporated by reference into this report.

Unaudited Pro Forma Redeemable Convertible Preferred Stock, Stockholders Equity and Income per Common Share

In July 2008, the Board of Directors authorized management to file a registration statement with the Securities and Exchange Commission for the Company to sell shares of its common stock to the public. If the initial public offering is completed, 22,148,453 shares of the company s preferred stock will convert into shares of common stock as of the closing of the offering. Unaudited pro forma preferred stock, stockholders equity and net income per common share basic and diluted, as adjusted for (i) the assumed conversion of the preferred stock to common stock, (ii) a deemed dividend for the value of contingent beneficial conversion feature associated with the preferred stock, and (iii) the reverse split of common stock is set forth in the accompanying consolidated balance sheet and statement of operations, respectively. Because the preferred stock value increases due to accrued dividends, the number of common shares issued in the conversion is not constant. If the offering had closed on June 30, 2009, the number of common shares issued in the conversion would have been 63,559,714 shares.

2. Accounting Policies

Use of Estimates

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

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (SFAS No. 168). SFAS No. 168

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

stipulates the FASB Accounting Standards Codification is the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. SFAS No. 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The implementation of this standard will not have a material impact on the Company s consolidated financial statements.

In June 2009, FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS No. 167). SFAS No. 167 changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting or similar rights should be consolidated. SFAS No. 167 will require a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure related to that involvement. SFAS No. 167 is effective for annual and interim reporting periods beginning after November 15, 2009. The adoption of SFAS No. 167 is not expected to have a material impact on the Company s consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets (SFAS No. 166). SFAS No. 166 is a revision to SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and will require additional disclosure about the transfers of financial assets, including securitization transactions, and additional disclosure in cases where entities have continuing exposure to the risks related to transferred financial assets. SFAS No. 166 eliminates the concept of qualifying special-purpose entity and changes the requirements for derecognizing financial assets. SFAS No. 166 is effective for annual and interim reporting periods beginning after November 15, 2009. The adoption of SFAS No. 166 is not expected to have a material impact on the Company s consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS No. 165). SFAS No. 165 provides general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The statement sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. The statement also sets forth the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements. Furthermore, this statement identifies the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The Company adopted SFAS No. 165 during the second quarter of 2009 and evaluated subsequent events through August 13, 2009, the original issuance date of the financial statements as of and for the three and six months ended June 30, 2009. The Company has evaluated subsequent events through September 9, 2009, the reissuance date of the financial statements as of and for the three and six months ended June 30, 2009.

In April 2009, FASB issued FASB Staff Position (FSP) No. 141R-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies (FSP 141R-1). FSP 141R-1 amends the provisions in Statement of Financial Accounting Standards (SFAS) No. 141R, Business Combinations, Revised (SFAS No. 141R), for the initial recognition and measurement, subsequent measurement and accounting, and disclosures for assets and liabilities arising from contingencies in business combinations. FSP 141R-1 eliminates the distinction between contractual and non-contractual contingencies, including the initial recognition and measurement criteria in SFAS No. 141R and instead carries forward most of the provisions in SFAS No. 141, Business Combinations, for acquired contingencies. FSP 141R-1 is effective for contingent assets and contingent liabilities acquired in business combinations for which the acquisition date is on or after the beginning of the first annual

reporting period beginning on or after December 15, 2008. The adoption of FSP 141R-1 did not have a material impact on the Company s consolidated financial statements.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which will require that the fair value disclosures for all financial instruments within the scope of SFAS No. 107, Disclosures about Fair Value of Financial Instruments, be included in interim financial statements. This FSP also requires entities to disclose the method and significant assumptions used to estimate the fair value of financial instruments on an interim and annual basis and to highlight any changes from prior periods.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

FSP FAS 107-1 and APB 28-1 was effective for interim periods ending after June 15, 2009. The adoption of FSP 107-1 and APB 28-1 did not have an impact on the Company s consolidated financial statements. See Note 9, *Fair Value of Financial Instruments*.

In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, provides additional guidance for estimating fair value in accordance with SFAS No. 157 when the volume and level of activity for the asset or liability have decreased significantly. FSP FAS 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly. The provisions of FSP FAS 157-4 were effective for the Company s interim period ending on June 30, 2009. The adoption of FSP FAS 157-4 did not have an impact on the Company s consolidated financial statements.

On January 1, 2009, the Company adopted SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 (SFAS No. 160). Upon adoption of this standard, minority interest is now referred to as non-controlling interest and has been reclassified from the mezzanine section of the balance sheet to the equity section. The balance sheet as of December 31, 2008 has been revised to show this change in presentation. In addition, non-controlling interest is now deducted from net income to obtain net income attributable to the Company.

3. Intangible Assets

The Company s intangible assets consist of the following:

	As of June 30, 2009	
	Gross Carrying Amount	Accumulated Amortization
	(in thousands)	
Amortized intangible assets		
Contract therapy relationships	$ 20,456	$ (17,729)
Non-compete agreements	25,909	(18,328)
Total	$ 46,365	$ (36,057)
Indefinite-lived intangible assets		
Goodwill	$ 1,506,661	
Trademarks	47,858	
Certificates of need	10,158	
Accreditations	1,339	
Total	$ 1,566,016	

On January 1, 2009 the Company adopted Financial Accounting Standards Board Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 provides guidance in determining the useful life of intangible assets that have renewal or extension terms and also requires additional disclosure related to these intangibles. The Company s accreditations and trademarks have renewal terms. The costs to renew these intangibles are expensed as incurred. At June 30, 2009, the accreditations and trademarks have a weighted average time until the next renewal of 1.7 years and 5.2 years, respectively.

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Amortization expense for the Company s intangible assets with finite lives follows:

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2009	Six Months Ended June 30, 2008	Six Months Ended June 30, 2009
	(in thousands)			
Amortization expense	$ 2,207	$ 2,208	$ 4,415	$ 4,416

Amortization expense for the Company s intangible assets primarily relates to the amortization of the value associated with the non-compete agreements entered into in connection with the acquisitions of the outpatient rehabilitation division of HealthSouth Corporation (the Division), Kessler Rehabilitation Corporation and SemperCare Inc. and the value assigned to the Company s contract therapy relationships. The useful lives of the Division s non-compete, Kessler non-compete, SemperCare non-compete and the Company s contract therapy relationships are approximately five, six, seven and five years, respectively.

Amortization expense related to these intangible assets for each of the next five years commencing January 1, 2009 is approximately as follows (in thousands):

2009	$ 8,831
2010	4,247
2011	1,306
2012	340
2013	0

4. Restructuring Reserves

In connection with the acquisition of the outpatient rehabilitation division of HealthSouth Corporation, the Company recorded a liability of $18.7 million in 2007 for business restructuring which was accounted for as additional purchase price. This reserve primarily included costs associated with workforce reductions and lease termination costs in accordance with the Company s restructuring plan.

The following summarizes the Company s restructuring activity:

	Lease Termination Costs	Severance	Other	Total
	(in thousands)			
December 31, 2008	$ 7,047	$ 992	$ 69	$ 8,108
Amounts paid in 2009	(1,685)	(362)		(2,047)

Revision of estimate		565		(496)		(69)		
June 30, 2009	$	5,927	$	134	$		$	6,061

The Company expects to pay out the remaining lease termination costs through 2016 and severance costs in 2009.

5. Accumulated Other Comprehensive Loss

Included in accumulated other comprehensive loss at December 31, 2008 and June 30, 2009 were cumulative losses of $13.2 million (net of tax) and $13.1 million (net of tax), respectively, on interest rate swaps accounted for as cash flow hedges.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

6. Fair Value Measurements

In the first quarter of 2008, the Company adopted SFAS No. 157, Fair Value Measurements with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities, which was adopted on January 1, 2009. This standard defines fair value, provides guidance for measuring fair value and requires certain disclosures. This standard does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements.

SFAS No. 157 discusses valuation techniques, such as the market approach, the income approach and the cost approach. The statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels as follows:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3: Unobservable inputs that reflect the reporting entity s own assumptions.

The Company measures its interest rate swaps at fair value on a recurring basis. The Company determines the fair value of its interest rate swaps based on financial models that consider current and future market interest rates and adjustments for non-performance risk. The Company considers those inputs utilized in the valuation process to be Level 2 in the fair value hierarchy. The fair value of the Company s interest rate swaps was a liability of $23.1 million at June 30, 2009 of which $20.5 million was reported as a current liability in accrued other and $2.6 million was reported in other long-term liabilities.

7. Segment Information

The Company s segments consist of (i) specialty hospitals and (ii) outpatient rehabilitation. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. All other primarily includes the Company s general and administrative services. The Company evaluates performance of the segments based on Adjusted EBITDA. Adjusted EBITDA is defined as net income before interest, income taxes, depreciation and amortization, gain on early retirement of debt, stock compensation expense and non-controlling interest.

The following tables summarize selected financial data for the Company s reportable segments for the three and six months ended June 30, 2008 and 2009.

	Three Months Ended June 30, 2008			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total

	(in thousands)			
Net operating revenue	$ 367,289	$ 171,495	$ 22	$ 538,806
Adjusted EBITDA	55,237	23,746	(12,194)	66,789
Total assets	1,925,514	510,248	108,275	2,544,037
Capital expenditures	7,400	2,962	689	11,051

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

	Three Months Ended June 30, 2009			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net operating revenue	$ 386,331	$ 173,190	$ 14	$ 559,535
Adjusted EBITDA	70,960	25,294	(12,628)	83,626
Total assets	1,920,040	492,936	119,706	2,532,682
Capital expenditures	11,222	2,199	524	13,945

	Six Months Ended June 30, 2008			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net operating revenue	$ 745,893	$ 341,072	$ 119	$ 1,087,084
Adjusted EBITDA	118,480	43,843	(23,039)	139,284
Total assets	1,925,514	510,248	108,275	2,544,037
Capital expenditures	17,388	6,813	1,906	26,107

	Six Months Ended June 30, 2009			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net operating revenue	$ 779,563	$ 341,009	$ 135	$ 1,120,707
Adjusted EBITDA	147,741	46,578	(25,041)	169,278
Total assets	1,920,040	492,936	119,706	2,532,682
Capital expenditures	15,377	5,009	595	20,981

A reconciliation of Adjusted EBITDA to income from operations before income taxes is as follows (in thousands):

	Three Months Ended June 30, 2008		
	Specialty Hospitals	Outpatient Rehabilitation	All Other
Adjusted EBITDA	$ 55,237	$ 23,746	$ (12,194)
Depreciation and amortization	(11,134)	(5,908)	(888)
Stock compensation expense			(438)

Income (loss) from operations	$ 44,103	$ 17,838	$ (13,520)	$ 48,421
Interest expense, net				(36,475)
Income from operations before income taxes				$ 11,946

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

	Three Months Ended June 30, 2009			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	
Adjusted EBITDA	$ 70,960	$ 25,294	$ (12,628)	
Depreciation and amortization	(10,790)	(6,264)	(885)	
Stock compensation expense			(299)	
Income (loss) from operations	$ 60,170	$ 19,030	$ (13,812)	$ 65,388
Gain on early retirement of debt				3,562
Interest expense, net				(33,630)
Income from operations before income taxes				$ 35,320

	Six Months Ended June 30, 2008			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	
Adjusted EBITDA	$ 118,480	$ 43,843	$ (23,039)	
Depreciation and amortization	(21,876)	(11,701)	(1,750)	
Stock compensation expense			(1,192)	
Income (loss) from operations	$ 96,604	$ 32,142	$ (25,981)	$ 102,765
Interest expense, net				(73,268)
Income from operations before income taxes				$ 29,497

	Six Months Ended June 30, 2009			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	
Adjusted EBITDA	$ 147,741	$ 46,578	$ (25,041)	
Depreciation and amortization	(21,537)	(12,397)	(1,736)	
Stock compensation expense			(594)	
Income (loss) from operations	$ 126,204	$ 34,181	$ (27,371)	$ 133,014
Gain on early retirement of debt				15,316
Interest expense, net				(68,250)

Income from operations before income taxes	$ 80,080

8. Net Income per Share

The Company adopted FASB Staff Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities (FSP EITF 03-6-1). FSP EITF 03-6-1 clarified that share based payment awards that have not yet vested do meet the definition of a participating security provided the right to receive the dividend is non-forfeitable and non-contingent. Participating securities are defined as securities that participate in dividends with common stock according to a predetermined formula. These

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

participating securities should be included in the computation of basic earnings per share under the two class method. In applying FSP EITF 03-6-1 the Company has concluded that its non-vested restricted stock awards meet the definition of a participating security and should be included in the Company s computation of basic earnings per share. In applying the two-class method, the Company determined that undistributed earnings should be allocated equally on a per share basis between common stock, unvested restricted stock and participating preferred stock due to the equal participation rights of the common stock, unvested restricted stock and participating preferred stock (i.e., the voting conversion rights) and losses should be allocated equally on a per share basis between common stock and participating preferred stock. The calculation of earnings per share for the three and six months ended June 30, 2008 has been revised to conform to the presentation prescribed in FSP EITF 03-6-1, however the adoption of FSP EITF 03-6-1 had no impact on earnings per share for the three and six months ended June 30, 2008.

The following table sets forth for the periods indicated the calculation of net income (loss) per share in the Company s consolidated statement of operations and the differences between basic weighted average shares outstanding and diluted weighted average shares outstanding used to compute basic and diluted earnings (loss) per share, respectively:

	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2008	2009	2008	2009
	(in thousands, except per share data)			
Numerator:				
Net income attributable to Select Medical Holdings Corporation	$ 5,753	$ 19,792	$ 14,453	$ 44,788
Less: Preferred stock dividends	6,195	6,508	12,279	12,870
Less: Earnings (loss) allocated to preferred stockholders	(44)	1,296	212	3,115
Less: Earnings allocated to unvested restricted stockholders		161	75	443
Income (loss) available to common and preferred stockholders basic and diluted	$ (398)	$ 11,827	$ 1,887	$ 28,360
Denominator:				
Weighted average shares basic	198,038	202,106	197,270	201,698
Effect of dilutive securities:				
Stock options		1,605		1,608
Weighted average shares diluted	198,038	203,711	197,270	203,306
Basic income (loss) per common share	$ (0.00)	$ 0.06	$ 0.01	$ 0.14
Diluted income (loss) per common share	$ (0.00)	$ 0.06	$ 0.01	$ 0.14

The following share amounts are shown here for informational and comparative purposes only since their inclusion would be anti-dilutive:

	For the Quarter Ended June 30,		For the Six Months Ended June 30,	
	2008	2009	2008	2009
	(in thousands)			
Stock options	4,654	470	4,599	453

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

9. Fair Value of Financial Instruments

During the quarter ended June 30, 2009, the Company adopted FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which requires that the fair value disclosures for all financial instruments within the scope of SFAS No. 107, Disclosures about Fair Value of Financial Instruments, be included in interim financial statements. Financial instruments include cash and cash equivalents, notes payable and long-term debt. The carrying amount of cash and cash equivalents approximates fair value because of the short-term maturity of these instruments. The carrying amount of Select s senior secured credit facility was $768.1 million at June 30, 2009 and the estimated fair value of the senior secured credit facility was $710.8 million at June 30, 2009. At June 30, 2009 the carrying value of the 75/8% senior subordinated notes was $611.5 million and the estimated fair value was $495.3 million. At June 30, 2009 the carrying value of the senior floating rate notes was $175.0 million and the estimated fair value was $126.0 million. The Company based the estimated fair value for its senior secured credit facility, 75/8% senior subordinated notes and senior floating rate notes on quotes from financial institutions.

Interest Rate Swaps

On January 1, 2009, the Company adopted SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS No. 161). This statement intends to improve transparency in financial reporting by requiring enhanced disclosures of an entity s derivative instruments and hedging activities and their effects on the entity s financial position, financial performance and cash flows. SFAS No. 161 applies to all derivative instruments within the scope of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133) as well as related hedged items, bifurcated derivatives and non-derivative instruments that are designated and qualify as hedging instruments.

The Company is exposed to the impact of interest rate changes. The Company s objective is to manage the impact of the interest rate changes on earnings and cash flows. On June 13, 2005, Select entered into an interest rate swap agreement to hedge Select s interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was August 22, 2005. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $200.0 million, and the underlying variable rate debt is associated with Select s senior secured credit facility. The variable interest rate of the debt was 2.7% and the fixed rate of the swap was 6.3% at June 30, 2009. The swap is for a period of five years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

On September 19, 2005, Select entered into an additional interest rate swap agreement to hedge Holdings interest rate risk for its senior floating rate notes. The effective date of the swap transaction was September 29, 2005. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $175.0 million, and the underlying variable rate debt is associated with Holdings $175.0 million senior floating rate notes due 2015. The variable interest rate of the debt was 7.7% and the fixed rate of the swap was 10.2% at June 30, 2009. The swap is for a period of four years, with semi-annual resets on March 15 and September 15 of each year.

On March 8, 2007, Select entered into an additional interest rate swap agreement to hedge Select s interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was

May 22, 2007. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $200.0 million, and the underlying variable rate debt is associated with Select s senior secured credit facility. The variable interest rate of the debt was 2.7% and the fixed rate of the swap was 6.8% at June 30, 2009. The swap is for a period of three years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

On November 16, 2007, Select entered into an additional interest rate swap agreement to hedge Select s interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap

SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

transaction was November 23, 2007. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $100.0 million, and the underlying variable rate debt is associated with Select s senior secured credit facility. The variable interest rate of the debt was 2.7% and the fixed rate of the swap was 6.3% at June 30, 2009. The swap is for a period of three years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

The interest rate swaps have been designated as hedges and qualify under the provision of SFAS No. 133 as effective hedges. See also, Note 5, *Accumulated Other Comprehensive Loss* and Note 6, *Fair Value Measurements*.

10. Early Retirement of Debt

During the first quarter of 2009, the Company paid approximately $19.0 million to repurchase and retire a portion of its 75/8% senior subordinated notes. These notes had a carrying value of $31.5 million. A gain on early retirement of debt in the amount of $11.8 million was recognized, which was net of the write-off of $0.7 million in unamortized deferred financing costs related to the debt. In the second quarter of 2009, the Company paid approximately $11.1 million to repurchase and retire additional 75/8% senior subordinated notes with a carrying value of $15.0 million. A gain on the early retirement of debt in the amount of $3.6 million was recognized in the second quarter of 2009 which was net of the write-off of $0.3 million in unamortized deferred financing cost related to the debt.

11. Commitments and Contingencies

Litigation

To cover claims arising out of the operations of the Company s specialty hospitals and outpatient rehabilitation facilities, the Company maintains professional malpractice liability insurance and general liability insurance. The Company also maintains umbrella liability insurance covering claims which, due to their nature or amount, are not covered by or not fully covered by the Company s other insurance policies. These insurance policies also do not generally cover punitive damages and are subject to various deductibles and policy limits. Significant legal actions as well as the cost and possible lack of available insurance could subject the Company to substantial uninsured liabilities.

The Company is subject to legal proceedings and claims that arise in the ordinary course of business, which include malpractice claims covered under insurance policies, subject to self-insured retention of $2.0 million per medical incident for professional liability claims and $2.0 million per occurrence for general liability claims. In the Company s opinion, the outcome of these actions will not have a material adverse effect on its financial position or results of operations.

Health care providers are subject to lawsuits under the qui tam provisions of the federal False Claims Act. Qui tam lawsuits typically remain under seal (hence, usually unknown to the defendant) for some time while the government decides whether or not to intervene on behalf of a private qui tam plaintiff (known as a relator) and take the lead in the litigation. These lawsuits can involve significant monetary damages and penalties and award bounties to private plaintiffs who successfully bring the suits. The Company has been a defendant in these cases in the past, and may be named as a defendant in similar cases from time to time in the future.

During July 2009, the Company received a subpoena from the Office of Inspector General of the U.S. Department of Health and Human Services seeking various documents concerning the Company s financial relationships with certain physicians practicing at its hospitals in Columbus, Ohio. The Company does not know whether the subpoena has been issued in connection with a qui tam lawsuit or in connection with possible civil, criminal or administrative proceedings by the government. The Company is assembling documents in order to respond to the subpoena and intends to fully cooperate with this investigation. At this time, the Company is unable to predict the timing and outcome of this matter.

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SELECT MEDICAL HOLDINGS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Construction Commitments

At June 30, 2009, the Company has outstanding commitments under construction contracts related to new construction, improvements and renovations at the Company s long term acute care properties and inpatient rehabilitation facilities totaling approximately $29.6 million.

12. Subsequent Events

On August 5, 2009 Select entered into an Amendment No. 3 (Amendment No. 3) to its senior secured credit facility. Amendment No. 3 extended the maturity of $384.5 million principal amount of Tranche B term loans from February 24, 2012 to August 22, 2014, and made related technical changes to the senior secured credit facility. Holders of Tranche B term loans that extended the maturity of their Tranche B term loans now hold Tranche B-1 term loans that mature on August 22, 2014, and holders of Tranche B term loans that did not extend the maturity of their Tranche B term loans continue to hold Tranche B term loans that mature on February 24, 2012. The applicable rate for the Tranche B-1 term loans under the senior secured credit facility has increased to 3.75% for adjusted LIBOR loans and 2.75% for alternate base rate loans. Under the terms of Amendment No. 3, if, prior to August 5, 2011, the senior secured credit facility is amended to reduce the applicable rate for the Tranche B-1 term loans, then Select will be required to pay a fee in an amount equal to 1% of the outstanding Tranche B-1 term loans held by those holders of Tranche B-1 term loans that agree to amend the senior secured credit facility to reduce the applicable rate. In addition, if, prior to August 5, 2011, Select makes any prepayment of Tranche B-1 term loans with proceeds of any term loan indebtedness, then Select will be required to pay a fee to holders of Tranche B-1 term loans in an amount equal to 1% of the outstanding Tranche B-1 term loans that are being prepaid.

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