

KINDRED HEALTHCARE, INC  
Form 10-Q  
November 06, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 001-14057

**KINDRED HEALTHCARE, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**680 South Fourth Street**

**Louisville, KY**  
(Address of principal executive offices)

**(502) 596-7300**

(Registrant's telephone number, including area code)

**61-1323993**  
(I.R.S. Employer  
Identification No.)

**40202-2412**  
(Zip Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject

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to such filing requirements for the past 90 days. Yes  No

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| <b>Class of Common Stock</b>   | <b>Outstanding at October 31, 2009</b> |
|--------------------------------|--|
| Common stock, \$0.25 par value | 39,076,717 shares                      |

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**KINDRED HEALTHCARE, INC.**

**FORM 10-Q**

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**Table of Contents****KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS****(Unaudited)****(In thousands, except per share amounts)**

|  | Three months ended<br>September 30, |             | Nine months ended<br>September 30, |              |
|--|-------------------------------------|-------------|------------------------------------|--------------|
|  | 2009                                | 2008        | 2009                               | 2008         |
| Revenues   | \$ 1,057,488                        | \$ 997,129  | \$ 3,200,016                       | \$ 3,057,645 |
| Salaries, wages and benefits                               | 629,077                             | 597,216     | 1,865,125                          | 1,776,872    |
| Supplies   | 82,400                              | 77,766      | 246,648                            | 236,369      |
| Rent   | 88,081                              | 84,865      | 260,164                            | 254,348      |
| Other operating expenses                                   | 221,524                             | 207,773     | 663,684                            | 645,290      |
| Other income   | (2,870)                             | (4,313)     | (8,565)                            | (14,197)     |
| Depreciation and amortization                              | 31,992                              | 29,174      | 93,837                             | 90,277       |
| Interest expense   | 1,741                               | 3,710       | 6,448                              | 11,538       |
| Investment income  | (746)                               | (671)       | (3,254)                            | (6,253)      |
|  | 1,051,199                           | 995,520     | 3,124,087                          | 2,994,244    |
| Income from continuing operations before income taxes      | 6,289                               | 1,609       | 75,929                             | 63,401       |
| Provision (benefit) for income taxes                       | 901                                 | (510)       | 29,662                             | 24,595       |
| Income from continuing operations                          | 5,388                               | 2,119       | 46,267                             | 38,806       |
| Discontinued operations, net of income taxes:              |                                     |             |                                    |              |
| Income (loss) from operations                              | 13                                  | (1,321)     | (1,465)                            | (4,369)      |
| Gain (loss) on divestiture of operations                   | 52                                  | (22,058)    | (23,999)                           | (19,346)     |
| Net income (loss)  | \$ 5,453                            | \$ (21,260) | \$ 20,803                          | \$ 15,091    |
| Earnings (loss) per common share:                          |                                     |             |                                    |              |
| Basic:   |                                     |             |                                    |              |
| Income from continuing operations                          | \$ 0.14                             | \$ 0.05     | \$ 1.19                            | \$ 1.00      |
| Discontinued operations:                                   |                                     |             |                                    |              |
| Income (loss) from operations                              |                                     | (0.03)      | (0.04)                             | (0.11)       |
| Gain (loss) on divestiture of operations                   |                                     | (0.57)      | (0.62)                             | (0.50)       |
| Net income (loss)  | \$ 0.14                             | \$ (0.55)   | \$ 0.53                            | \$ 0.39      |
| Diluted:   |                                     |             |                                    |              |
| Income from continuing operations                          | \$ 0.14                             | \$ 0.05     | \$ 1.18                            | \$ 0.98      |
| Discontinued operations:                                   |                                     |             |                                    |              |
| Income (loss) from operations                              |                                     | (0.03)      | (0.04)                             | (0.11)       |
| Gain (loss) on divestiture of operations                   |                                     | (0.56)      | (0.61)                             | (0.49)       |
| Net income (loss)  | \$ 0.14                             | \$ (0.54)   | \$ 0.53                            | \$ 0.38      |
| Shares used in computing earnings (loss) per common share: |                                     |             |                                    |              |
| Basic  | 38,398                              | 38,034      | 38,297                             | 37,732       |

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|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Diluted | 38,524 | 38,894 | 38,419 | 38,485 |
|---------|--------|--------|--------|--------|

See accompanying notes.

**Table of Contents****KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED BALANCE SHEET****(Unaudited)****(In thousands, except per share amounts)**

|   | September 30,<br>2009 | December 31,<br>2008 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Current assets:   |                       |                      |
| Cash and cash equivalents   | \$ 45,303             | \$ 140,795           |
| Cash restricted   | 6,165                 | 5,104                |
| Insurance subsidiary investments  | 159,830               | 196,983              |
| Accounts receivable less allowance for loss of \$23,832 September 30, 2009 and \$27,548 December 31, 2008   | 665,360               | 611,032              |
| Inventories   | 21,863                | 22,325               |
| Deferred tax assets   | 52,796                | 58,296               |
| Income taxes  | 22,407                | 47,257               |
| Other   | 19,303                | 20,843               |
|   | 993,027               | 1,102,635            |
| Property and equipment  | 1,491,683             | 1,392,636            |
| Accumulated depreciation  | (742,135)             | (656,676)            |
|   | 749,548               | 735,960              |
| Goodwill  | 81,223                | 72,244               |
| Intangible assets less accumulated amortization of \$2,425 September 30, 2009 and \$1,817 December 31, 2008 | 64,712                | 64,367               |
| Assets held for sale  | 20,733                | 7,786                |
| Insurance subsidiary investments  | 50,890                | 48,610               |
| Deferred tax assets   | 110,249               | 100,751              |
| Other   | 58,527                | 49,408               |
|   | \$ 2,128,909          | \$ 2,181,761         |

**LIABILITIES AND STOCKHOLDERS EQUITY**

|  |            |            |
|--|------------|------------|
| Current liabilities:                   |            |            |
| Accounts payable                       | \$ 161,505 | \$ 178,246 |
| Salaries, wages and other compensation | 296,611    | 281,542    |
| Due to third party payors              | 30,827     | 33,122     |
| Professional liability risks           | 47,128     | 55,447     |
| Other accrued liabilities              | 85,368     | 76,832     |
| Long-term debt due within one year     | 84         | 81         |
|  | 621,523    | 625,270    |
| Long-term debt                         | 251,070    | 349,433    |
| Professional liability risks           | 208,451    | 187,804    |
| Deferred credits and other liabilities | 104,843    | 104,279    |
| Commitments and contingencies          |            |            |

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| Stockholders' equity:   |                    |  |
|---|--------------------|--|
| Common stock, \$0.25 par value; authorized 175,000 shares; issued 39,074 shares | September 30, 2009 |  |
| and 38,909 shares   | December 31, 2008  |  |
|   |                    | 9,769                      9,727       |
| Capital in excess of par value  |                    | 817,947                    812,141     |
| Accumulated other comprehensive loss  |                    | (2,223)                    (3,619)     |
| Retained earnings   |                    | 117,529                    96,726      |
|   |                    | 943,022                    914,975     |
|   |                    | \$ 2,128,909              \$ 2,181,761 |

See accompanying notes.

**Table of Contents****KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS****(Unaudited)****(In thousands)**

|  | Three months ended<br>September 30, |                 | Nine months ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
|  | 2009                                | 2008            | 2009                               | 2008            |
| <b>Cash flows from operating activities:</b>   |                                     |                 |                                    |                 |
| Net income (loss)  | \$ 5,453                            | \$ (21,260)     | \$ 20,803                          | \$ 15,091       |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                     |                 |                                    |                 |
| Depreciation and amortization  | 31,992                              | 29,595          | 94,511                             | 92,269          |
| Amortization of stock-based compensation costs   | 2,449                               | 2,411           | 7,548                              | 9,806           |
| Provision for doubtful accounts  | 7,100                               | 6,877           | 21,747                             | 22,037          |
| Deferred income taxes  | 4,286                               | 8,226           | (5,221)                            | (4,921)         |
| (Gain) loss on divestiture of discontinued operations                                    | (52)                                | 22,058          | 23,999                             | 19,346          |
| Other  | (1,428)                             | (853)           | (1,192)                            | (1,946)         |
| Change in operating assets and liabilities:  |                                     |                 |                                    |                 |
| Accounts receivable  | (11,934)                            | (41,141)        | (76,075)                           | (125,287)       |
| Inventories and other assets   | (2,194)                             | (422)           | (11,755)                           | (4,880)         |
| Accounts payable   | 3,876                               | (2,726)         | (6,392)                            | (13,756)        |
| Income taxes   | (7,727)                             | (17,796)        | 38,374                             | 21,188          |
| Due to third party payors  | 5,413                               | 14,998          | (4,340)                            | 191             |
| Other accrued liabilities  | 15,580                              | 7,262           | 37,841                             | 12,251          |
| <b>Net cash provided by operating activities</b>   | <b>52,814</b>                       | <b>7,229</b>    | <b>139,848</b>                     | <b>41,389</b>   |
| <b>Cash flows from investing activities:</b>   |                                     |                 |                                    |                 |
| Purchase of property and equipment   | (33,975)                            | (47,293)        | (112,857)                          | (112,153)       |
| Acquisitions   | (8,035)                             | (22,419)        | (83,432)                           | (48,824)        |
| Sale of assets   | 14,019                              | 745             | 14,019                             | 27,984          |
| Purchase of insurance subsidiary investments   | (18,808)                            | (25,908)        | (77,480)                           | (94,976)        |
| Sale of insurance subsidiary investments   | 17,658                              | 22,568          | 97,677                             | 89,501          |
| Net change in insurance subsidiary cash and cash equivalents                             | 1,177                               | 1,671           | 16,852                             | 40,099          |
| Change in other investments  | 2                                   | 2               | 2,002                              | 7,002           |
| Other  | (517)                               | 1,340           | 3,877                              | 2,628           |
| <b>Net cash used in investing activities</b>   | <b>(28,479)</b>                     | <b>(69,294)</b> | <b>(139,342)</b>                   | <b>(88,739)</b> |
| <b>Cash flows from financing activities:</b>   |                                     |                 |                                    |                 |
| Proceeds from borrowings under revolving credit  | 295,600                             | 391,700         | 952,500                            | 1,119,800       |
| Repayment of borrowings under revolving credit   | (319,300)                           | (328,800)       | (1,050,800)                        | (1,066,500)     |
| Repayment of long-term debt  | (20)                                | (19)            | (60)                               | (57)            |
| Repayment of capital lease obligation  |                                     |                 |                                    | (16,268)        |
| Payment of deferred financing costs  | (177)                               | (211)           | (604)                              | (390)           |
| Issuance of common stock   | 568                                 | 3,087           | 568                                | 8,865           |
| Other  | 4,570                               | (3,213)         | 2,398                              | (11,682)        |
| <b>Net cash provided by (used in) financing activities</b>                               | <b>(18,759)</b>                     | <b>62,544</b>   | <b>(95,998)</b>                    | <b>33,768</b>   |



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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Change in cash and cash equivalents              | 5,576     | 479       | (95,492)  | (13,582)  |
| Cash and cash equivalents at beginning of period | 39,727    | 18,816    | 140,795   | 32,877    |
| Cash and cash equivalents at end of period       | \$ 45,303 | \$ 19,295 | \$ 45,303 | \$ 19,295 |

Supplemental information:

|                               |          |          |          |           |
|-------------------------------|----------|----------|----------|-----------|
| Interest payments             | \$ 1,491 | \$ 3,214 | \$ 5,398 | \$ 10,847 |
| Income tax payments (refunds) | 6,092    | 9,614    | (2,711)  | 6,924     |

See accompanying notes.

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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1 BASIS OF PRESENTATION**

*Business*

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates hospitals, nursing centers and a contract rehabilitation services business across the United States (collectively, the Company). At September 30, 2009, the Company's hospital division operated 82 long-term acute care (LTAC) hospitals in 24 states. The Company's health services division operated 222 nursing centers in 27 states. The Company also operated a contract rehabilitation services business that provides rehabilitative services primarily in long-term care settings.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains, losses or impairments associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2009 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 2 for a summary of discontinued operations.

*Recently issued accounting requirements*

In August 2009, the Financial Accounting Standards Board (the FASB) issued authoritative guidance related to fair value measurements and disclosures. The provisions of this guidance clarify how an entity should measure liabilities at fair value. The guidance is effective for all interim and annual reporting periods beginning after August 26, 2009. The adoption of the guidance did not have a material impact on the Company's business, financial position, results of operations or liquidity.

In June 2009, the FASB issued authoritative guidance for establishment of the FASB's Accounting Standards Codification (the FASB Codification), which identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. The FASB Codification is the sole source of authoritative accounting principles recognized by the FASB. The guidance is effective for all financial statements issued for interim and annual reporting periods ending after September 15, 2009. The application of this guidance (or the FASB Codification) did not have an impact on the Company's business, financial position, results of operations or liquidity.

In May 2009, the FASB issued authoritative guidance which establishes 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 new provisions provide guidance related to the disclosure date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. The guidance is effective for all interim and annual reporting periods beginning after June 15, 2009. The adoption of the guidance did not have an impact on the Company's business, financial position, results of operations or liquidity.

In April 2009, the FASB issued additional authoritative guidance related to fair value measurements and the recognition of other-than-temporary impairments of financial instruments. The new provisions provide guidance to determine whether the market for a security is inactive and whether transactions in inactive markets are distressed and clarify the recognition and measurement of other-than-temporary impairments of debt and equity

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 1 BASIS OF PRESENTATION (Continued)***Recently issued accounting requirements (Continued)*

securities. Authoritative guidance also was issued for interim disclosures about fair value of financial instruments, which requires an entity to provide disclosures about the fair value of financial instruments in both interim and annual financial statements. The guidance is effective for all interim and annual reporting periods beginning after June 15, 2009. The adoption of the guidance did not have a material impact on the Company's business, financial position, results of operations or liquidity.

On January 1, 2009, the Company adopted the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings (loss) per common share calculation pursuant to the two-class method. The adoption of the guidance has been applied retrospectively in the accompanying unaudited condensed consolidated financial statements and did not have a material impact on the Company's earnings (loss) per common share calculations. See Note 5.

In December 2007, the FASB revised the authoritative guidance for business combinations, which significantly changes the accounting for business combinations, including, among other changes, new accounting concepts in determining the fair value of assets and liabilities acquired, recording the fair value of contingent considerations and contingencies at the acquisition date and expensing acquisition and restructuring costs. The guidance is applied prospectively and is effective for business combinations which occur during fiscal years beginning after December 15, 2008. The Company's adoption of the guidance on January 1, 2009 did not have a material impact on the Company's business, financial position, results of operations or liquidity at September 30, 2009 or for the nine months ended September 30, 2009. However, any future business combinations may significantly impact the Company's financial position and results of operations when compared to acquisitions accounted for under the previous guidance and may result in generally lower earnings due to the expensing of acquisition and restructuring costs.

In April 2009, the FASB issued authoritative guidance for accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies, which will amend the provisions related to the initial recognition and measurement, subsequent measurement and disclosure of assets and liabilities arising from contingencies in a business combination. The guidance is effective for all business combinations which occur during fiscal years beginning after December 15, 2008. The Company's adoption of the guidance retroactive to January 1, 2009 did not have a material impact on the Company's business, financial position, results of operations or liquidity.

*Comprehensive income (loss)*

The following table sets forth the computation of comprehensive income (loss) (in thousands):

|   | <b>Three months ended</b> |                    | <b>Nine months ended</b> |                  |
|---|---------------------------|--------------------|--------------------------|------------------|
|   | <b>September 30,</b>      |                    | <b>September 30,</b>     |                  |
|   | <b>2009</b>               | <b>2008</b>        | <b>2009</b>              | <b>2008</b>      |
| Net income (loss)   | \$ 5,453                  | \$ (21,260)        | \$ 20,803                | \$ 15,091        |
| Net unrealized investment gains (losses), net of income taxes | 1,081                     | (1,269)            | 1,396                    | (3,037)          |
| <b>Comprehensive income (loss)</b>                            | <b>\$ 6,534</b>           | <b>\$ (22,529)</b> | <b>\$ 22,199</b>         | <b>\$ 12,054</b> |

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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 1 BASIS OF PRESENTATION (Continued)**

*Other information*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2008 filed with the Securities and Exchange Commission (the SEC) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2008 was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company's customary accounting practices. Management believes that financial information included herein reflects all adjustments necessary for a fair presentation of interim results and, except as otherwise disclosed, all such adjustments are of a normal and recurring nature.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles and include amounts based upon the estimates and judgments of management. Actual amounts may differ from those estimates.

The Company has performed an evaluation of subsequent events through November 6, 2009, which is the date the financial statements were issued.

*Reclassifications*

Certain prior period amounts have been reclassified to conform with the current period presentation. These changes did not have any impact on the Company's business, financial position, results of operations or liquidity.

**NOTE 2 DISCONTINUED OPERATIONS**

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestiture of unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the gains, losses or impairments related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations.

In June 2009, the Company purchased for resale six under-performing nursing centers (the Nursing Centers) previously leased from Ventas, Inc. (Ventas) for \$55.7 million. In addition, the Company paid a lease termination fee of \$2.3 million. The Nursing Centers were included in the Company's master lease agreements with Ventas and the Company does not have the ability to terminate a lease of an individual facility. The aggregate annual rent for the Nursing Centers was approximately \$6 million for the year ended December 31, 2008. The Nursing Centers, which contained 777 licensed beds, generated pretax losses of approximately \$3 million for the year ended December 31, 2008 and approximately \$2 million for the nine months ended September 30, 2009. The Company disposed of three of the Nursing Centers in September 2009 for \$14.0 million, which did not result in a gain or loss. During the third quarter of 2009, the Company increased the fair value of the remaining three Nursing Centers by \$2.2 million based upon updated expected proceeds negotiated with potential purchasers and recorded a pretax loss provision of \$2.0 million related to the expected recapture of third party revenues upon disposal. The Company recorded a pretax loss of \$39.0 million (\$24.0 million net of income taxes) for the nine months ended September 30, 2009 related to these divestitures.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 2 DISCONTINUED OPERATIONS (Continued)**

In September 2008, the Company purchased for resale a LTAC hospital for \$22.3 million that was previously leased. The Company recorded a pretax loss of \$35.9 million (\$22.1 million net of income taxes) in the third quarter of 2008 resulting from the losses related to the purchase, closure and planned divestiture of the hospital, including the impairment of a certificate of need intangible asset (\$15.2 million), the impairment of property and equipment (\$16.3 million) and other costs (\$4.4 million).

In September 2008, the Company also announced its intention to dispose of another LTAC hospital and its related operations. The hospital operations have been closed but the Company continues to operate a co-located 64-bed skilled nursing unit. The Company recorded a pretax loss of \$5.1 million (\$3.1 million net of income taxes) in the second quarter of 2008 related to the impairment of the hospital's building and equipment.

At September 30, 2009, the Company held for sale three nursing centers and two hospitals. The Company expects to generate \$12.9 million in net proceeds from the sales of the remaining three Nursing Centers and \$7.8 million in net proceeds from the sales of the two hospitals. The Company disposed of two of the Nursing Centers in October 2009 for \$12.2 million, which will not result in a gain or loss. The Company intends to dispose of the remaining Nursing Center and the two hospitals as soon as practicable.

The Company also discontinued the operations of a hospital in the third quarter of 2008 after terminating the hospital's operating lease and closing the operations.

The Company recorded a pretax gain of \$9.5 million (\$5.9 million net of income taxes) related to the divestiture of discontinued operations during the nine months ended September 30, 2008.

A summary of discontinued operations follows (in thousands):

|   | <b>Three months ended<br/>September 30,</b> |             | <b>Nine months ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2009</b>                                 | <b>2008</b> | <b>2009</b>                                | <b>2008</b> |
| Revenues  | \$ 17,068                                   | \$ 21,838   | \$ 50,150                                  | \$ 89,198   |
| Salaries, wages and benefits                                  | 10,077                                      | 13,616      | 29,064                                     | 53,973      |
| Supplies  | 1,017                                       | 1,644       | 3,001                                      | 6,602       |
| Rent  | 223   | 2,296       | 3,520                                      | 7,446       |
| Other operating expenses                                      | 5,734                                       | 5,991       | 16,274                                     | 26,300      |
| Depreciation  |   | 421         | 674  | 1,992       |
| Interest expense  | 2   |             | 9  | 2           |
| Investment income   | (7)   | 18          | (11)                                       | (12)        |
|   | 17,046                                      | 23,986      | 52,531                                     | 96,303      |
| Income (loss) from operations before income taxes             | 22  | (2,148)     | (2,381)                                    | (7,105)     |
| Provision (benefit) for income taxes                          | 9   | (827)       | (916)                                      | (2,736)     |
| Income (loss) from operations                                 | 13  | (1,321)     | (1,465)                                    | (4,369)     |
| Gain (loss) on divestiture of operations, net of income taxes | 52  | (22,058)    | (23,999)                                   | (19,346)    |

\$ 65      \$ (23,379)      \$ (25,464)      \$ (23,715)

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 2 DISCONTINUED OPERATIONS (Continued)**

The following table sets forth certain discontinued operating data by business segment (in thousands):

|                                 | <b>Three months ended<br/>September 30,</b> |             | <b>Nine months ended<br/>September 30,</b> |             |
|---------------------------------|---|-------------|--|-------------|
|                                 | <b>2009</b>                                 | <b>2008</b> | <b>2009</b>                                | <b>2008</b> |
| <b>Revenues:</b>                |   |             |  |             |
| Hospital division               | \$ 1,469                                    | \$ 6,727    | \$ 3,818                                   | \$ 32,799   |
| Health services division        | 15,599                                      | 15,111      | 46,332                                     | 56,399      |
|                                 | \$ 17,068                                   | \$ 21,838   | \$ 50,150                                  | \$ 89,198   |
| <b>Operating income (loss):</b> |   |             |  |             |
| Hospital division               | \$ (547)                                    | \$ (672)    | \$ (2,039)                                 | \$ (3,775)  |
| Health services division        | 787   | 1,259       | 3,850                                      | 6,098       |
|                                 | \$ 240                                      | \$ 587      | \$ 1,811                                   | \$ 2,323    |
| <b>Rent:</b>                    |   |             |  |             |
| Hospital division               | \$ 63                                       | \$ 714      | \$ 164                                     | \$ 2,723    |
| Health services division        | 160   | 1,582       | 3,356                                      | 4,723       |
|                                 | \$ 223                                      | \$ 2,296    | \$ 3,520                                   | \$ 7,446    |
| <b>Depreciation:</b>            |   |             |  |             |
| Hospital division               | \$  | \$ 163      | \$   | \$ 852      |
| Health services division        |   | 258         | 674  | 1,140       |
|                                 | \$  | \$ 421      | \$ 674                                     | \$ 1,992    |

A summary of the net assets held for sale follows (in thousands):

|   | <b>September 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|---|-------------------------------|------------------------------|
| <b>Long-term assets:</b>                                    |                               |                              |
| Property and equipment, net                                 | \$ 20,596                     | \$ 7,730                     |
| Other   | 137                           | 56                           |
|   | 20,733                        | 7,786                        |
| Current liabilities (included in other accrued liabilities) | (625)                         | (111)                        |

\$ 20,108

\$ 7,675



**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 3 SIGNIFICANT QUARTERLY ADJUSTMENTS**

The provision for income taxes for the third quarter of 2009 and for the nine months ended September 30, 2009 included a favorable adjustment of \$1.7 million related to the resolution of certain income tax contingencies from prior years.

Operating results for the third quarter of 2008 included a \$0.9 million pretax other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio that reduced investment income in the accompanying unaudited condensed consolidated statement of operations. In addition, the provision for income taxes included a favorable adjustment of \$1.8 million related to the resolution of certain income tax contingencies from prior years.

Operating results for the nine months ended September 30, 2008 also included pretax income of \$8.3 million related to the favorable settlement of a prior year nursing center Medicaid cost report dispute and a pretax charge of \$1.9 million related to a prior period rent escalator adjustment for ten leased facilities.

**NOTE 4 REVENUES**

Revenues are recorded based upon estimated amounts due from patients and third party payors for healthcare services provided, including anticipated settlements under reimbursement agreements with Medicare, Medicaid, Medicare Advantage and other third party payors.

A summary of revenues by payor type follows (in thousands):

|                    | Three months ended<br>September 30, |            | Nine months ended<br>September 30, |              |
|--------------------|-------------------------------------|------------|------------------------------------|--------------|
|                    | 2009                                | 2008       | 2009                               | 2008         |
| Medicare           | \$ 437,845                          | \$ 408,721 | \$ 1,356,872                       | \$ 1,307,103 |
| Medicaid           | 276,461                             | 272,811    | 811,788                            | 798,530      |
| Medicare Advantage | 77,670                              | 65,486     | 242,515                            | 192,524      |
| Other              | 337,935                             | 315,626    | 1,003,974                          | 957,240      |
|                    | 1,129,911                           | 1,062,644  | 3,415,149                          | 3,255,397    |
| Eliminations       | (72,423)                            | (65,515)   | (215,133)                          | (197,752)    |
|                    | \$ 1,057,488                        | \$ 997,129 | \$ 3,200,016                       | \$ 3,057,645 |

**NOTE 5 EARNINGS (LOSS) PER SHARE**

Earnings (loss) per common share are based upon the weighted average number of common shares outstanding during the respective periods. The diluted calculation of earnings (loss) per common share includes the dilutive effect of stock options. On January 1, 2009, the Company adopted the provisions of the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings (loss) per common share calculation pursuant to the two-class method.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 5 EARNINGS (LOSS) PER SHARE (Continued)**

A computation of earnings (loss) per common share follows (in thousands, except per share amounts):

|  | Three months ended September 30, |          |             |             | Nine months ended September 30, |             |             |             |
|--|----------------------------------|----------|-------------|-------------|---------------------------------|-------------|-------------|-------------|
|  | 2009                             |          | 2008        |             | 2009                            |             | 2008        |             |
|  | Basic                            | Diluted  | Basic       | Diluted     | Basic                           | Diluted     | Basic       | Diluted     |
| <b>Earnings (loss):</b>                                      |                                  |          |             |             |                                 |             |             |             |
| <b>Income from continuing operations:</b>                    |                                  |          |             |             |                                 |             |             |             |
| As reported in Statement of Operations                       | \$ 5,388                         | \$ 5,388 | \$ 2,119    | \$ 2,119    | \$ 46,267                       | \$ 46,267   | \$ 38,806   | \$ 38,806   |
| Allocation to participating unvested restricted stockholders | (90)                             | (90)     | (46)        | (45)        | (833)                           | (830)       | (915)       | (897)       |
| Available to common stockholders                             | \$ 5,298                         | \$ 5,298 | \$ 2,073    | \$ 2,074    | \$ 45,434                       | \$ 45,437   | \$ 37,891   | \$ 37,909   |
| <b>Discontinued operations, net of income taxes:</b>         |                                  |          |             |             |                                 |             |             |             |
| <b>Income (loss) from operations:</b>                        |                                  |          |             |             |                                 |             |             |             |
| As reported in Statement of Operations                       | \$ 13                            | \$ 13    | \$ (1,321)  | \$ (1,321)  | \$ (1,465)                      | \$ (1,465)  | \$ (4,369)  | \$ (4,369)  |
| Allocation to participating unvested restricted stockholders |                                  |          | 29          | 28          | 26                              | 26          | 103         | 101         |
| Available to common stockholders                             | \$ 13                            | \$ 13    | \$ (1,292)  | \$ (1,293)  | \$ (1,439)                      | \$ (1,439)  | \$ (4,266)  | \$ (4,268)  |
| <b>Gain (loss) on divestiture of operations:</b>             |                                  |          |             |             |                                 |             |             |             |
| As reported in Statement of Operations                       | \$ 52                            | \$ 52    | \$ (22,058) | \$ (22,058) | \$ (23,999)                     | \$ (23,999) | \$ (19,346) | \$ (19,346) |
| Allocation to participating unvested restricted stockholders | (1)                              | (1)      | 475         | 465         | 432                             | 431         | 456         | 447         |
| Available to common stockholders                             | \$ 51                            | \$ 51    | \$ (21,583) | \$ (21,593) | \$ (23,567)                     | \$ (23,568) | \$ (18,890) | \$ (18,899) |
| <b>Net income (loss):</b>                                    |                                  |          |             |             |                                 |             |             |             |
| As reported in Statement of Operations                       | \$ 5,453                         | \$ 5,453 | \$ (21,260) | \$ (21,260) | \$ 20,803                       | \$ 20,803   | \$ 15,091   | \$ 15,091   |
| Allocation to participating unvested restricted stockholders | (91)                             | (91)     | 458         | 448         | (375)                           | (373)       | (356)       | (349)       |
| Available to common stockholders                             | \$ 5,362                         | \$ 5,362 | \$ (20,802) | \$ (20,812) | \$ 20,428                       | \$ 20,430   | \$ 14,735   | \$ 14,742   |
| <b>Shares used in the computation:</b>                       |                                  |          |             |             |                                 |             |             |             |
| Weighted average shares outstanding basic computation        | 38,398                           | 38,398   | 38,034      | 38,034      | 38,297                          | 38,297      | 37,732      | 37,732      |
| Dilutive effect of employee stock options                    |                                  | 126      |             | 860         |                                 | 122         |             | 753         |

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|  |    |      |        |      |        |        |        |        |        |        |      |      |      |      |      |      |
|--|----|------|--------|------|--------|--------|--------|--------|--------|--------|------|------|------|------|------|------|
| Adjusted weighted average shares outstanding   |    |      | 38,524 |      | 38,894 |        | 38,419 |        | 38,485 |        |      |      |      |      |      |      |
| Earnings (loss) per common share:  |    |      |        |      |        |        |        |        |        |        |      |      |      |      |      |      |
| Income from continuing operations  | \$ | 0.14 | \$     | 0.14 | \$     | 0.05   | \$     | 0.05   | \$     | 1.19   | \$   | 1.18 | \$   | 1.00 | \$   | 0.98 |
| Discontinued operations:   |    |      |        |      |        |        |        |        |        |        |      |      |      |      |      |      |
| Income (loss) from operations  |    |      |        |      | (0.03) | (0.03) | (0.04) | (0.04) | (0.11) | (0.11) |      |      |      |      |      |      |
| Gain (loss) on divestiture of operations   |    |      |        |      | (0.57) | (0.56) | (0.62) | (0.61) | (0.50) | (0.49) |      |      |      |      |      |      |
| Net income (loss)  | \$ | 0.14 | \$     | 0.14 | \$     | (0.55) | (0.54) | \$     | 0.53   | \$     | 0.53 | \$   | 0.39 | \$   | 0.38 |      |
| Number of antidilutive stock options excluded from shares used in the diluted earnings (loss) per common share computation |    |      |        |      |        |        |        |        |        |        |      |      |      |      |      |      |
|  |    |      | 3,021  |      | 317    |        | 3,030  |        | 403    |        |      |      |      |      |      |      |

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 6 BUSINESS SEGMENT DATA**

At September 30, 2009, the Company operated three business segments: the hospital division, the health services division and the rehabilitation division. The hospital division operates LTAC hospitals. The health services division operates nursing centers. The rehabilitation division provides rehabilitation services primarily in long-term care settings. For segment purposes, the Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company's business segments excludes the allocation of corporate overhead.

The Company identifies its segments in accordance with the aggregation provisions of the authoritative guidance for segment reporting. This information is consistent with information used by the Company in managing its businesses and aggregates businesses with similar economic characteristics.

The following table sets forth certain data by business segment (in thousands):

|   | Three months ended<br>September 30, |            | Nine months ended<br>September 30, |              |
|---|-------------------------------------|------------|------------------------------------|--------------|
|   | 2009                                | 2008       | 2009                               | 2008         |
| <b>Revenues:</b>                                      |                                     |            |                                    |              |
| Hospital division                                     | \$ 468,069                          | \$ 434,774 | \$ 1,447,723                       | \$ 1,372,005 |
| Health services division                              | 539,217                             | 521,074    | 1,606,704                          | 1,565,779    |
| Rehabilitation division                               | 122,625                             | 106,796    | 360,722                            | 317,613      |
|   | 1,129,911                           | 1,062,644  | 3,415,149                          | 3,255,397    |
| Eliminations  | (72,423)                            | (65,515)   | (215,133)                          | (197,752)    |
|   | \$ 1,057,488                        | \$ 997,129 | \$ 3,200,016                       | \$ 3,057,645 |
| <b>Income from continuing operations:</b>             |                                     |            |                                    |              |
| Operating income (loss):                              |                                     |            |                                    |              |
| Hospital division                                     | \$ 78,674                           | \$ 64,818  | \$ 270,600                         | \$ 247,506   |
| Health services division                              | 73,383                              | 79,133     | 228,479                            | 240,386      |
| Rehabilitation division                               | 10,912                              | 7,448      | 39,964                             | 29,112       |
| Corporate:  |                                     |            |                                    |              |
| Overhead  | (33,843)                            | (30,937)   | (101,516)                          | (99,068)     |
| Insurance subsidiary                                  | (1,769)                             | (1,775)    | (4,403)                            | (4,625)      |
|   | (35,612)                            | (32,712)   | (105,919)                          | (103,693)    |
| Operating income                                      | 127,357                             | 118,687    | 433,124                            | 413,311      |
| Rent  | (88,081)                            | (84,865)   | (260,164)                          | (254,348)    |
| Depreciation and amortization                         | (31,992)                            | (29,174)   | (93,837)                           | (90,277)     |
| Interest, net   | (995)                               | (3,039)    | (3,194)                            | (5,285)      |
| Income from continuing operations before income taxes | 6,289                               | 1,609      | 75,929                             | 63,401       |

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|                                      |          |          |           |           |
|--------------------------------------|----------|----------|-----------|-----------|
| Provision (benefit) for income taxes | 901      | (510)    | 29,662    | 24,595    |
|                                      | \$ 5,388 | \$ 2,119 | \$ 46,267 | \$ 38,806 |

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 6 BUSINESS SEGMENT DATA (Continued)**

|  | <b>Three months ended<br/>September 30,</b> |             | <b>Nine months ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2009</b>                                 | <b>2008</b> | <b>2009</b>                                | <b>2008</b> |
| <b>Rent:</b>   |   |             |  |             |
| Hospital division  | \$ 37,062                                   | \$ 36,461   | \$ 110,341                                 | \$ 110,118  |
| Health services division   | 49,471                                      | 46,972      | 145,310                                    | 139,909     |
| Rehabilitation division  | 1,495                                       | 1,405       | 4,405                                      | 4,156       |
| Corporate  | 53  | 27          | 108  | 165         |
|  | \$ 88,081                                   | \$ 84,865   | \$ 260,164                                 | \$ 254,348  |
| <b>Depreciation and amortization:</b>  |   |             |  |             |
| Hospital division  | \$ 13,275                                   | \$ 11,719   | \$ 38,805                                  | \$ 34,477   |
| Health services division   | 12,408                                      | 11,536      | 36,131                                     | 38,720      |
| Rehabilitation division  | 584   | 547         | 1,680                                      | 1,419       |
| Corporate  | 5,725                                       | 5,372       | 17,221                                     | 15,661      |
|  | \$ 31,992                                   | \$ 29,174   | \$ 93,837                                  | \$ 90,277   |
| <b>Capital expenditures, excluding acquisitions (including discontinued operations):</b> |   |             |  |             |
| Hospital division  | \$ 21,110                                   | \$ 19,736   | \$ 53,170                                  | \$ 53,314   |
| Health services division   | 6,371                                       | 19,746      | 40,157                                     | 37,625      |
| Rehabilitation division  | 269   | 271         | 631  | 833         |
| Corporate:   |   |             |  |             |
| Information systems  | 6,152                                       | 7,051       | 18,443                                     | 19,499      |
| Other  | 73  | 489         | 456  | 882         |
|  | \$ 33,975                                   | \$ 47,293   | \$ 112,857                                 | \$ 112,153  |

|                                 | <b>September 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|---------------------------------|-------------------------------|------------------------------|
| <b>Assets at end of period:</b> |                               |                              |
| Hospital division               | \$ 888,198                    | \$ 847,394                   |
| Health services division        | 606,824                       | 574,710                      |
| Rehabilitation division         | 59,965                        | 45,733                       |
| Corporate                       | 573,922                       | 713,924                      |
|                                 | \$ 2,128,909                  | \$ 2,181,761                 |

**Goodwill:**

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|                          |    |        |    |        |
|--------------------------|----|--------|----|--------|
| Hospital division        | \$ | 68,577 | \$ | 68,577 |
| Health services division |    | 889    |    | 639    |
| Rehabilitation division  |    | 11,757 |    | 3,028  |
|                          | \$ | 81,223 | \$ | 72,244 |

In July 2009, the Company acquired a hospice business for \$8.0 million, which included \$6.9 million of goodwill and \$0.9 million of intangible assets. The Company includes operating data for its hospice businesses in the rehabilitation division.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 INSURANCE RISKS**

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon management's best available information including actuarially determined estimates.

The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These liabilities are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. To the extent that expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

The provision for loss for insurance risks, including the cost of coverage maintained with unaffiliated commercial insurance carriers, follows (in thousands):

|                         | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|-------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                         | 2009                                | 2008     | 2009                               | 2008      |
| Professional liability: |                                     |          |                                    |           |
| Continuing operations   | \$ 12,095                           | \$ 4,305 | \$ 41,888                          | \$ 30,057 |
| Discontinued operations | 692                                 | (859)    | 1,200                              | (2,078)   |
| Workers compensation:   |                                     |          |                                    |           |
| Continuing operations   | \$ 8,803                            | \$ 7,148 | \$ 27,966                          | \$ 23,425 |
| Discontinued operations | (32)                                | 307      | (922)                              | 1,279     |

A summary of the assets and liabilities related to insurance risks included in the accompanying unaudited condensed consolidated balance sheet follows (in thousands):

|                                  | September 30, 2009     |                      |            | December 31, 2008      |                      |            |
|----------------------------------|------------------------|----------------------|------------|------------------------|----------------------|------------|
|                                  | Professional liability | Workers compensation | Total      | Professional liability | Workers compensation | Total      |
| <b>Assets:</b>                   |                        |                      |            |                        |                      |            |
| Current:                         |                        |                      |            |                        |                      |            |
| Insurance subsidiary investments | \$ 76,472              | \$ 83,358            | \$ 159,830 | \$ 109,494             | \$ 87,489            | \$ 196,983 |
| Reinsurance recoverables         | 89                     |                      | 89         | 89                     |                      | 89         |
| Other                            |                        | 321                  | 321        |                        |                      |            |
|                                  | 76,561                 | 83,679               | 160,240    | 109,583                | 87,489               | 197,072    |
| Non-current:                     |                        |                      |            |                        |                      |            |
| Insurance subsidiary investments | 50,890                 |                      | 50,890     | 48,610                 |                      | 48,610     |
| Reinsurance recoverables         | 26,443                 | 1,523                | 27,966     | 17,167                 |                      | 17,167     |
| Deposits                         | 5,000                  | 1,409                | 6,409      | 2,000                  | 1,466                | 3,466      |
| Other                            |                        | 47                   | 47         |                        | 142                  | 142        |
|                                  | 82,333                 | 2,979                | 85,312     | 67,777                 | 1,608                | 69,385     |



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|  |            |    |        |            |            |    |        |            |
|--|------------|----|--------|------------|------------|----|--------|------------|
|  | \$ 158,894 | \$ | 86,658 | \$ 245,552 | \$ 177,360 | \$ | 89,097 | \$ 266,457 |
|--|------------|----|--------|------------|------------|----|--------|------------|

**Liabilities:**

Allowance for insurance risks:

|         |           |    |        |           |           |    |        |           |
|---------|-----------|----|--------|-----------|-----------|----|--------|-----------|
| Current | \$ 47,128 | \$ | 24,004 | \$ 71,132 | \$ 55,447 | \$ | 25,348 | \$ 80,795 |
|---------|-----------|----|--------|-----------|-----------|----|--------|-----------|

|             |         |  |        |         |         |  |        |         |
|-------------|---------|--|--------|---------|---------|--|--------|---------|
| Non-current | 208,451 |  | 59,611 | 268,062 | 187,804 |  | 57,993 | 245,797 |
|-------------|---------|--|--------|---------|---------|--|--------|---------|

|  |            |    |        |            |            |    |        |            |
|--|------------|----|--------|------------|------------|----|--------|------------|
|  | \$ 255,579 | \$ | 83,615 | \$ 339,194 | \$ 243,251 | \$ | 83,341 | \$ 326,592 |
|--|------------|----|--------|------------|------------|----|--------|------------|

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 INSURANCE RISKS (Continued)**

Provisions for loss for professional liability risks retained by the Company's limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 2% for the 2009 policy year, 3% for the 2008 policy year and 5% for all prior policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated

\$261.6 million at September 30, 2009 and \$251.8 million at December 31, 2008.

Provisions for loss for workers compensation risks retained by the Company's limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually.

**NOTE 8 INSURANCE SUBSIDIARY INVESTMENTS**

The Company maintains investments, consisting principally of cash and cash equivalents, asset backed securities, corporate bonds, equities, commercial paper and U.S. Treasury notes for the payment of claims and expenses related to professional liability and workers compensation risks. These investments have been categorized as available-for-sale and are reported at fair value.

The amortized cost and estimated fair value of the Company's insurance subsidiary investments follow (in thousands):

|                               | September 30, 2009 |                  |                   |            | December 31, 2008 |                  |                   |            |
|-------------------------------|--------------------|------------------|-------------------|------------|-------------------|------------------|-------------------|------------|
|                               | Amortized cost     | Unrealized gains | Unrealized losses | Fair value | Amortized cost    | Unrealized gains | Unrealized losses | Fair value |
| Cash and cash equivalents (a) | \$ 101,296         | \$               | \$                | \$ 101,296 | \$ 118,148        | \$               | \$                | \$ 118,148 |
| Asset backed securities       | 40,550             | 517              | (106)             | 40,961     | 59,509            | 886              | (292)             | 60,103     |
| Corporate bonds               | 39,744             | 939              | (7)               | 40,676     | 35,110            | 314              | (698)             | 34,726     |
| Equities                      | 14,213             | 802              | (2,577)           | 12,438     | 13,750            | 402              | (3,307)           | 10,845     |
| Commercial paper              | 10,099             | 13               | (5)               | 10,107     | 9,825             | 34               |                   | 9,859      |
| U.S. Treasury notes           | 5,179              | 63               |                   | 5,242      | 11,760            | 152              |                   | 11,912     |
|                               | \$ 211,081         | \$ 2,334         | \$ (2,695)        | \$ 210,720 | \$ 248,102        | \$ 1,788         | \$ (4,297)        | \$ 245,593 |

(a) Includes \$5.4 million and \$13.2 million of money market funds at September 30, 2009 and December 31, 2008, respectively. The Company's investment policy governing insurance subsidiary investments precludes the investment portfolio managers from selling any security at a loss without prior authorization from the Company. The investment managers also limit the exposure to any one issue, issuer or type of investment. The Company intends, and has the ability, to hold insurance subsidiary investments for a long duration without the necessity of selling securities to fund the underwriting needs of its insurance subsidiary. This ability to hold securities allows sufficient time for recovery of temporary declines in the market value of equity securities and the par value of debt securities as of their stated maturity date.

The Company considered the unrealized losses related to its insurance subsidiary investments at September 30, 2009 to be temporary and did not record any impairment losses related to these investments in the third quarter or the nine months ended September 30, 2009. The Company

considered the severity and duration

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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 8 INSURANCE SUBSIDIARY INVESTMENTS (Continued)**

of its unrealized losses at September 30, 2008 and recognized during the third quarter of 2008 a \$0.9 million pretax other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio.

The decrease in total fair value of insurance subsidiary investments at September 30, 2009 from December 31, 2008 was primarily attributable to a \$34 million distribution in March 2009 from the insurance subsidiary to the Company. This distribution resulted from improved professional liability underwriting results in prior years of the Company's limited purpose insurance subsidiary.

**NOTE 9 LEASES**

In April 2009, the Company provided Ventas with notices to renew the master lease agreements for an additional five years for 87 nursing centers and 22 LTAC hospitals (collectively, the Renewal Facilities). The initial lease term for the Renewal Facilities was scheduled to expire in April 2010. The Company's option to renew the leases on the Renewal Facilities would have expired on April 30, 2009. No additional rent or other consideration was paid in connection with these renewals. The effectiveness of the renewals is contingent upon there being no events of default under the master lease agreements in April 2010.

**NOTE 10 INCOME TAXES**

During the third quarter of 2009, the Company reduced its unrecognized tax benefits and related accrued interest by \$2.7 million. The deferred tax asset associated with unrecognized tax benefits also was reduced by \$1.0 million. As of September 30, 2009, the Company's unrecognized tax benefits totaled \$7.6 million and accrued interest related to uncertain tax positions totaled \$0.1 million.

The federal statute of limitations remains open for tax years 2006 through 2008.

State jurisdictions generally have statutes of limitations ranging from three to five years. The state impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification to the states. Currently, the Company has various state income tax returns under examination.

**NOTE 11 CONTINGENCIES**

Management continually evaluates contingencies based upon the best available information. In addition, allowances for losses are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claimed in current cost reports and tax returns.

Management believes that allowances for losses have been provided to the extent necessary and that its assessment of contingencies is reasonable.

Principal contingencies are described below:

*Revenues* Certain third party payments are subject to examination by agencies administering the various reimbursement programs. The Company is contesting certain issues raised in audits of prior year cost reports.

*Professional liability risks* The Company has provided for loss for professional liability risks based upon management's best available information including actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Note 7.



**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 11 CONTINGENCIES (Continued)**

*Income taxes* The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties. In addition, the Company is a party to a tax matters agreement with PharMerica Corporation which sets forth the Company's rights and obligations related to taxes for periods before and after the Company's spin-off of its former institutional pharmacy business in 2007 and the related merger transaction which created PharMerica Corporation.

*Litigation* The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. These legal actions and investigations could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The U.S. Department of Justice (the "DOJ"), the Centers for Medicare and Medicaid Services ("CMS") or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company's businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company's business, financial position, results of operations and liquidity.

*Other indemnifications* In the ordinary course of business, the Company enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction such as a disposal of an operating facility. These indemnifications may cover claims related to employment-related matters, governmental regulations, environmental issues and tax matters, as well as patient, third party payor, supplier and contractual relationships. Obligations under these indemnities generally are initiated by a breach of the terms of a contract or by a third party claim or event.

**NOTE 12 FAIR VALUE OF ASSETS AND LIABILITIES**

On January 1, 2008, the Company adopted the provisions of the authoritative guidance for fair value measurements, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency asset backed debt securities that are highly liquid and are actively traded in over-the-counter markets.
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.



**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 12 FAIR VALUE OF ASSETS AND LIABILITIES (Continued)**

The Company's assets and liabilities measured at fair value on a recurring and non-recurring basis and any associated gains or losses are summarized below (in thousands):

|                                     | Fair value measurements |            |           | Assets/liabilities<br>at fair value | Total<br>gains (losses) |
|-------------------------------------|-------------------------|------------|-----------|-------------------------------------|-------------------------|
|                                     | Level 1                 | Level 2    | Level 3   |                                     |                         |
| <b>September 30, 2009:</b>          |                         |            |           |                                     |                         |
| Recurring:                          |                         |            |           |                                     |                         |
| Assets:                             |                         |            |           |                                     |                         |
| Available-for-sale securities       | \$ 23,039               | \$ 91,743  | \$        | \$ 114,782                          | \$                      |
| Deposits held in money market funds | 16,384                  |            |           | 16,384                              |                         |
|                                     | \$ 39,423               | \$ 91,743  | \$        | \$ 131,166                          | \$                      |
| Liabilities                         | \$                      | \$         | \$        | \$                                  | \$                      |
| Non-recurring:                      |                         |            |           |                                     |                         |
| Assets:                             |                         |            |           |                                     |                         |
| Nursing centers available for sale  | \$                      | \$         | \$ 13,199 | \$ 13,199                           | \$ 2,200                |
| Liabilities                         | \$                      | \$         | \$        | \$                                  | \$                      |
| <b>December 31, 2008:</b>           |                         |            |           |                                     |                         |
| Recurring:                          |                         |            |           |                                     |                         |
| Assets:                             |                         |            |           |                                     |                         |
| Available-for-sale securities       | \$ 35,960               | \$ 104,688 | \$        | \$ 140,648                          | \$                      |
| Deposits held in money market funds | 124,539                 |            |           | 124,539                             |                         |
|                                     | \$ 160,499              | \$ 104,688 | \$        | \$ 265,187                          | \$                      |
| Liabilities                         | \$                      | \$         | \$        | \$                                  | \$                      |

*Recurring measurements*

The Company's available-for-sale securities are held by its wholly owned limited purpose insurance subsidiary and are comprised of money market funds, asset backed securities, corporate bonds, equities, commercial paper and U.S. Treasury notes. These available-for-sale securities and the insurance subsidiary's cash and cash equivalents of \$95.9 million as of September 30, 2009, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company's deposits held in money market funds consist primarily of cash and cash equivalents held for general corporate purposes.

The fair value of actively traded debt and equity securities and money market funds are based upon quoted market prices and are generally classified as Level 1. The fair value of inactive traded debt securities are based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and are generally classified as Level 2.





**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 12 FAIR VALUE OF ASSETS AND LIABILITIES (Continued)***Recurring measurements (Continued)*

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments. The carrying value is equal to fair value for financial instruments that are based upon quoted market prices or current market rates.

| <b>(In thousands)</b>                                 | <b>September 30, 2009</b> |                   | <b>December 31, 2008</b> |                   |
|---|---------------------------|-------------------|--------------------------|-------------------|
|   | <b>Carrying value</b>     | <b>Fair value</b> | <b>Carrying value</b>    | <b>Fair value</b> |
| Cash and cash equivalents                             | \$ 45,303                 | \$ 45,303         | \$ 140,795               | \$ 140,795        |
| Cash restricted                                       | 6,165                     | 6,165             | 5,104                    | 5,104             |
| Insurance subsidiary investments                      | 210,720                   | 210,720           | 245,593                  | 245,593           |
| Tax refund escrow investments                         | 215                       | 215               | 216                      | 216               |
| Long-term debt, including amounts due within one year | 251,154                   | 251,113           | 349,514                  | 349,503           |

*Non-recurring measurements*

In June 2009, the Company purchased the Nursing Centers from Ventas for \$55.7 million. In addition, the Company paid a lease termination fee of \$2.3 million. The Company used unobservable inputs for the valuation methodology that are significant to the fair value measurement and required management's judgment related to the assumptions market participants would use in pricing the assets. The valuation of these assets also included sales comparisons of similar properties and past transactions, in addition to expected proceeds negotiated with potential purchasers. In aggregate, the assets had a carrying value of \$61.4 million and were adjusted to a fair value of \$27.2 million, less expected selling costs of \$1.2 million, resulting in an impairment charge of \$35.4 million (\$21.8 million net of income taxes).

In September 2009, the Company sold three of the Nursing Centers for \$14.0 million, which did not result in a gain or loss. The fair value of the remaining Nursing Centers was increased by \$2.2 million in the third quarter of 2009 based upon updated expected proceeds negotiated with potential purchasers. In addition, during the third quarter of 2009, the Company recorded a pretax loss provision of \$2.0 million (\$1.3 million net of income taxes) related to the expected recapture of third party revenues upon disposal. For the nine months ended September 30, 2009, the Company also recorded charges of \$1.6 million (\$0.9 million net of income taxes) related to the lease terminations net of unamortized deferred rent credits.

The Company disposed of two of the Nursing Centers in October 2009 for \$12.2 million, which will not result in a gain or loss.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Cautionary Statement**

This Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All statements regarding the Company's expected future financial position, results of operations, cash flows, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities, plans and objectives of management and statements containing words such as anticipate, approximate, believe, plan, estimate, expect, project, could, should, will, intend, may and other similar expressions, are forward-looking statements.

Such forward-looking statements are inherently uncertain, and stockholders and other potential investors must recognize that actual results may differ materially from the Company's expectations as a result of a variety of factors, including, without limitation, those discussed below. Such forward-looking statements are based upon management's current expectations and include known and unknown risks, uncertainties and other factors, many of which the Company is unable to predict or control, that may cause the Company's actual results or performance to differ materially from any future results or performance expressed or implied by such forward-looking statements. These statements involve risks, uncertainties and other factors discussed below and detailed from time to time in the Company's filings with the SEC. Factors that may affect the Company's plans or results include, without limitation:

changes in the reimbursement rates or the methods or timing of payment from third party payors, including the Medicare and Medicaid programs, changes arising from and related to the Medicare prospective payment system for LTAC hospitals ( LTAC PPS ), including potential changes in the Medicare payment rules, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and changes in Medicare and Medicaid reimbursements for the Company's nursing centers,

the effects of healthcare reform, legislative changes and government regulations, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare industry,

the impact of the Medicare, Medicaid and SCHIP Extension Act of 2007 (the SCHIP Extension Act ), including the ability of the Company's hospitals to adjust to potential LTAC certification, medical necessity reviews and the three-year moratorium on future hospital development,

failure of the Company's facilities to meet applicable licensure and certification requirements,

the further consolidation of managed care organizations and other third party payors,

the Company's ability to meet its rental and debt service obligations,

the Company's ability to operate pursuant to the terms of its debt obligations and its master lease agreements with Ventas,

the condition of the financial markets, including volatility and deterioration in the equity, capital and credit markets, which could limit the availability and terms of debt and equity financing sources to fund the requirements of the Company's businesses, or which could negatively impact the Company's investment portfolio,

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national and regional economic, financial, business and political conditions, including their effect on the availability and cost of labor, credit, materials and other services,

the Company's ability to control costs, particularly labor and employee benefit costs,

increased operating costs due to shortages in qualified nurses, therapists and other healthcare personnel,

the Company's ability to attract and retain key executives and other healthcare personnel,

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Cautionary Statement (Continued)**

the increase in the costs of defending and insuring against alleged professional liability claims and the Company's ability to predict the estimated costs related to such claims, including the impact of differences in actuarial assumptions and estimates compared to eventual outcomes,

the Company's ability to successfully reduce (by divestiture of operations or otherwise) its exposure to professional liability claims,

the Company's ability to successfully pursue its development activities and successfully integrate new operations, including the realization of anticipated revenues, economies of scale, cost savings and productivity gains associated with such operations,

the Company's ability to successfully dispose of unprofitable facilities,

events or circumstances which could result in impairment of an asset or other charges,

changes in generally accepted accounting principles or practices, and

the Company's ability to maintain an effective system of internal control over financial reporting.

Many of these factors are beyond the Company's control. The Company cautions investors that any forward-looking statements made by the Company are not guarantees of future performance. The Company disclaims any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments.

**General**

The accompanying unaudited condensed consolidated financial statements, including the notes thereto, should be read in conjunction with the following discussion and analysis.

The Company is a healthcare services company that through its subsidiaries operates hospitals, nursing centers and a contract rehabilitation services business across the United States. At September 30, 2009, the Company's hospital division operated 82 LTAC hospitals (6,520 licensed beds) in 24 states. The Company's health services division operated 222 nursing centers (27,571 licensed beds) in 27 states. The Company also operated a contract rehabilitation services business that provides rehabilitative services primarily in long-term care settings.

In recent years, the Company has completed several strategic divestitures to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains, losses or impairments associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2009 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet.

**Critical Accounting Policies**

Management's discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that affect the reported amounts and related disclosures of commitments and

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contingencies. The Company relies on historical experience and on various other assumptions that management believes to be reasonable under the circumstances to make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Critical Accounting Policies (Continued)**

The Company believes the following critical accounting policies, among others, affect the more significant judgments and estimates used in the preparation of its consolidated financial statements.

*Revenue recognition*

The Company has agreements with third party payors that provide for payments to each of its operating divisions. These payment arrangements may be based upon prospective rates, reimbursable costs, established charges, discounted charges or per diem payments. Net patient service revenue is recorded at the estimated net realizable amounts from Medicare, Medicaid, Medicare Advantage, other third party payors and individual patients for services rendered. Retroactive adjustments that are likely to result from future examinations by third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted as necessary in future periods based upon new information or final settlements.

Operating results for the nine months ended September 30, 2008 included pretax income of approximately \$8 million related to the favorable settlement of a prior year nursing center Medicaid cost report dispute.

*Collectibility of accounts receivable*

Accounts receivable consist primarily of amounts due from the Medicare and Medicaid programs, other government programs, managed care health plans, commercial insurance companies and individual patients and customers. Estimated provisions for doubtful accounts are recorded to the extent it is probable that a portion or all of a particular account will not be collected.

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of the change.

The provision for doubtful accounts totaled \$7 million and \$6 million for the third quarter of 2009 and 2008, respectively, and \$22 million and \$20 million for the nine months ended September 30, 2009 and 2008, respectively.

*Allowances for insurance risks*

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon management's best available information including actuarially determined estimates.

The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These liabilities are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. To the extent that expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

Provisions for loss for professional liability risks retained by the Company's limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 2% for the 2009 policy year, 3% for the 2008 policy year and 5% for all prior policy years. The discount rates

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Critical Accounting Policies (Continued)**

*Allowances for insurance risks (Continued)*

are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. The allowance for professional liability risks aggregated \$256 million at September 30, 2009 and \$243 million at December 31, 2008. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated \$262 million at September 30, 2009 and \$252 million at December 31, 2008.

The Company received distributions from its limited purpose insurance subsidiary of \$34 million and \$39 million during the nine months ended September 30, 2009 and 2008, respectively, as a result of improved professional liability underwriting results in prior years. These proceeds were used to repay borrowings under the Company's revolving credit facility and had no impact on earnings.

Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between the Company's estimated and actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. For example, a 1% variance in the allowance for professional liability risks at September 30, 2009 would impact the Company's operating income by approximately \$3 million.

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$13 million and \$4 million for the third quarter of 2009 and 2008, respectively, and \$42 million and \$30 million for the nine months ended September 30, 2009 and 2008, respectively. Professional liability costs rose substantially in the third quarter of 2009 primarily because the Company recognized larger favorable prior year adjustments in 2008 resulting from changes in estimates.

Provisions for loss for workers compensation risks retained by the Company's limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually. The allowance for workers compensation risks aggregated \$84 million at September 30, 2009 and \$83 million at December 31, 2008. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$9 million and \$7 million for the third quarter of 2009 and 2008, respectively, and \$28 million and \$23 million for the nine months ended September 30, 2009 and 2008, respectively.

*Accounting for income taxes*

The provision for income taxes is based upon the Company's estimate of annual taxable income or loss for each respective accounting period. The Company recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Company also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards. A valuation allowance is provided for these deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized.

The Company's effective income tax rate for the third quarter and nine months ended September 30, 2009 was favorably impacted by approximately \$2 million related to the resolution of certain income tax contingencies from

prior years, while the Company's effective income tax rate for the third quarter and nine months ended



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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Critical Accounting Policies (Continued)**

*Accounting for income taxes (Continued)*

September 30, 2008 was also favorably impacted by approximately \$2 million related to the resolution of certain income tax contingencies from prior years.

There are significant uncertainties with respect to capital loss carryforwards that could materially affect the realization of certain deferred tax assets. Accordingly, the Company has recognized deferred tax assets to the extent it is more likely than not they will be realized and a valuation allowance is provided for deferred tax assets to the extent that it is uncertain that the deferred tax asset will be realized. The Company recognized net deferred tax assets totaling \$163 million at September 30, 2009 and \$159 million at December 31, 2008.

The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties. While the Company believes its tax positions are appropriate, there can be no assurance that the various authorities engaged in the examination of its income tax returns will not challenge the Company's positions.

*Valuation of long-lived assets and goodwill*

The Company regularly reviews the carrying value of certain long-lived assets and identifiable intangible assets with respect to any events or circumstances that indicate an impairment or an adjustment to the amortization period is necessary. If circumstances suggest the recorded amounts cannot be recovered based upon estimated future undiscounted cash flows, the carrying values of such assets are reduced to fair value.

In assessing the carrying values of long-lived assets, the Company estimates future cash flows at the lowest level for which there are independent, identifiable cash flows. For this purpose, these cash flows are aggregated based upon the contractual agreements underlying the operation of the facility or group of facilities. Generally, an individual facility is considered the lowest level for which there are independent, identifiable cash flows. However, to the extent that groups of facilities are leased under a master lease agreement in which the operations of a facility and compliance with the lease terms are interdependent upon other facilities in the agreement (including the Company's ability to renew the lease or divest a particular property), the Company defines the group of facilities under a master lease agreement as the lowest level for which there are independent, identifiable cash flows. Accordingly, the estimated cash flows of all facilities within a master lease agreement are aggregated for purposes of evaluating the carrying values of long-lived assets.

The Company's other intangible assets with finite lives are amortized in accordance with the authoritative guidance for goodwill and other intangible assets using the straight-line method over their estimated useful lives ranging from one to ten years.

In accordance with the guidance for goodwill and other intangible assets, the Company is required to perform an impairment test for goodwill and indefinite lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. The Company performs its annual goodwill impairment test at the end of each fiscal year for each of its reporting units. A reporting unit is either an operating segment or one level below the operating segment, referred to as a component. When the components within the Company's operating segments have similar economic characteristics, the Company aggregates the components of its operating segments into one reporting unit. The Company has determined that its reporting units are hospitals, nursing centers, rehabilitation services and hospice.

The goodwill impairment test involves a two-step process. The first step is a comparison of each reporting unit's fair value to its carrying value. If the carrying value of the reporting unit is greater than its fair value, there is an indication that impairment may exist and the second step must be performed to measure the amount of

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Critical Accounting Policies (Continued)**

*Valuation of long-lived assets and goodwill (Continued)*

impairment loss. Based upon the results of the step one impairment test for goodwill and the impairment test of indefinite lived intangible assets, no impairment charges were recorded in connection with the Company's annual impairment tests at December 31, 2008.

Since quoted market prices for the Company's reporting units are not available, the Company applies judgment in determining the fair value of these reporting units for purposes of performing the goodwill impairment test. The Company relies on widely accepted valuation techniques, including equally weighted discounted cash flows and market multiple analyses approaches, which capture both the future income potential of the reporting unit and the market behaviors and actions of market participants in the industry that includes the reporting unit. These types of analyses require management to make assumptions and estimates regarding future cash flows, industry-specific economic factors and the profitability of future business strategies. The discounted cash flow approach uses a projection of estimated operating results and cash flows that are discounted using a weighted average cost of capital. Under the discounted cash flow approach, the projection uses management's best estimates of economic and market conditions over the projected period including growth rates in the number of admissions, patient days, reimbursement rates, operating costs, rent expense and capital expenditures. Other significant estimates and assumptions include terminal value growth rates, changes in working capital requirements and weighted average cost of capital. The market multiple analysis estimates fair value by applying cash flow multiples to the reporting unit's operating results. The multiples are derived from comparable publicly traded companies with similar operating and investment characteristics to the reporting units.

The fair values of the Company's indefinite lived intangible assets, primarily hospital certificates of need, are estimated using an excess earnings method, a form of discounted cash flows, which is based upon the concept that net after-tax cash flows provide a return supporting all of the assets of a business operation. The fair values of the Company's indefinite lived intangible assets are derived from projections which include management's best estimates of economic and market conditions over the projected period including growth rates in the number of admissions, patient days, reimbursement rates, operating costs, rent expense and capital expenditures. Other significant estimates and assumptions include terminal value growth rates, changes in working capital requirements and weighted average cost of capital.

The Company has determined that during the first nine months of 2009 there were no events or changes in circumstances since December 31, 2008 requiring an interim impairment test. Although the Company has determined that there was no goodwill or other indefinite lived intangible asset impairments as of September 30, 2009 and December 31, 2008, continued declines in the value of the Company's common stock or adverse changes in the operating environment and related key assumptions used to determine the fair value of the Company's reporting units and indefinite lived intangible assets may result in future impairment charges for a portion or all of these assets. An impairment charge could have a material adverse effect on the Company's business, financial position and results of operations, but would not be expected to have an impact on the Company's cash flows or liquidity.

**Recently Issued Accounting Requirements**

In August 2009, the FASB issued authoritative guidance related to fair value measurements and disclosures. The provisions of this guidance clarify how an entity should measure liabilities at fair value. The guidance is effective for all interim and annual reporting periods beginning after August 26, 2009. The adoption of the guidance did not have a material impact on the Company's business, financial position, results of operations or liquidity.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Recently Issued Accounting Requirements (Continued)**

In June 2009, the FASB issued authoritative guidance for establishment of the FASB Codification, which identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. The FASB Codification is the sole source of authoritative accounting principles recognized by the FASB. The guidance is effective for all financial statements issued for interim and annual reporting periods ending after September 15, 2009. The application of this guidance (or the FASB Codification) did not have an impact on the Company's business, financial position, results of operations or liquidity.

In May 2009, the FASB issued authoritative guidance which establishes 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 new provisions provide guidance related to the disclosure date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. The guidance is effective for all interim and annual reporting periods beginning after June 15, 2009. The adoption of the guidance did not have an impact on the Company's business, financial position, results of operations or liquidity.

In April 2009, the FASB issued additional authoritative guidance related to fair value measurements and the recognition of other-than-temporary impairments of financial instruments. The new provisions provide guidance to determine whether the market for a security is inactive and whether transactions in inactive markets are distressed and clarify the recognition and measurement of other-than-temporary impairments of debt and equity securities. Authoritative guidance also was issued for interim disclosures about fair value of financial instruments, which requires an entity to provide disclosures about the fair value of financial instruments in both interim and annual financial statements. The guidance is effective for all interim and annual reporting periods beginning after June 15, 2009. The adoption of the guidance did not have a material impact on the Company's business, financial position, results of operations or liquidity.

On January 1, 2009, the Company adopted the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings (loss) per common share calculation pursuant to the two-class method. The adoption of the guidance has been applied retrospectively in the accompanying unaudited condensed consolidated financial statements and did not have a material impact on the Company's earnings (loss) per common share calculations.

In December 2007, the FASB revised the authoritative guidance for business combinations, which significantly changes the accounting for business combinations, including, among other changes, new accounting concepts in determining the fair value of assets and liabilities acquired, recording the fair value of contingent considerations and contingencies at the acquisition date and expensing acquisition and restructuring costs. The guidance is applied prospectively and is effective for business combinations which occur during fiscal years beginning after December 15, 2008. The Company's adoption of the guidance on January 1, 2009 did not have a material impact on the Company's business, financial position, results of operations or liquidity at September 30, 2009 or for the nine months ended September 30, 2009. However, any future business combinations may significantly impact the Company's financial position and results of operations when compared to acquisitions accounted for under the previous guidance and may result in generally lower earnings due to the expensing of acquisition and restructuring costs.

In April 2009, the FASB issued authoritative guidance for accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies, which will amend the provisions related to the

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Recently Issued Accounting Requirements (Continued)**

initial recognition and measurement, subsequent measurement and disclosure of assets and liabilities arising from contingencies in a business combination. The guidance is effective for all business combinations which occur during fiscal years beginning after December 15, 2008. The Company's adoption of the guidance retroactive to January 1, 2009 did not have a material impact on the Company's business, financial position, results of operations or liquidity.

**Results of Operations – Continuing Operations*****Hospital division***

Revenues increased 8% in the third quarter of 2009 to \$468 million compared to \$435 million in the third quarter of 2008 and increased 6% to \$1.4 billion for the nine months ended September 30, 2009 compared to the same period in 2008. Revenue growth in both periods was primarily a result of increases in admissions, ongoing development of new hospitals and reimbursement rate increases associated with higher average patient acuity levels. Aggregate admissions increased 4% in the third quarter of 2009 and 1% for the nine months ended September 30, 2009 compared to the same periods last year. On a same-facility basis, aggregate admissions rose 4% in the third quarter of 2009 and rose 2% for the nine months ended September 30, 2009 compared to the same periods in 2008. Non-government same-facility admissions rose 11% in the third quarter of 2009 and rose 12% for the nine months ended September 30, 2009 compared to the same periods in 2008.

Hospital operating margins increased in the third quarter of 2009 and for the nine months ended September 30, 2009 compared to the same periods in 2008 as reimbursement rate increases for the third quarter of 2009 and the nine months ended September 30, 2009 exceeded the increased costs of providing services to higher acuity patients. Operating results for the third quarter of 2008 also included approximately \$6 million related to direct costs and operating declines in the Company's Louisiana and southern Texas hospital operations resulting from hurricane activities.

Hospital wage and benefit costs increased 4% to \$218 million in the third quarter of 2009 from \$211 million in the same period in 2008 and increased 4% to \$657 million for the nine months ended September 30, 2009 from \$635 million in the same period in 2008. Average hourly wage rates grew 3% in both the third quarter of 2009 and for the nine months ended September 30, 2009 compared to the respective prior year periods. Employee benefit costs increased 9% in the third quarter of 2009 and 8% for the nine months ended September 30, 2009 compared to the respective prior year periods, primarily as a result of increased employee health insurance costs.

Professional liability costs were \$5 million and \$2 million in the third quarter of 2009 and 2008, respectively, and \$18 million and \$11 million for the nine months ended September 30, 2009 and 2008, respectively.

***Health services division***

Revenues increased 3% in the third quarter of 2009 to \$538 million compared to \$521 million in the third quarter of 2008 and increased 3% to \$1.6 billion for the nine months ended September 30, 2009 compared to the same period in 2008. Revenue growth in both periods was primarily attributable to reimbursement rate increases that reflected both inflationary adjustments and higher average patient acuity. On a same-facility basis, aggregate patient days declined 1% in the third quarter of 2009 and declined 2% for the nine months ended September 30, 2009 compared to the respective prior year periods. Same-facility Medicare patient days declined 2% while non-government same-facility patient days increased 2% in the third quarter of 2009 compared to the same period in 2008. Same-facility Medicare patient days declined 5% while non-government same-facility patient days increased 2% for the nine months ended September 30, 2009 compared to the same period in 2008.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Results of Operations – Continuing Operations (Continued)**

***Health services division (Continued)***

Operating results for the nine months ended September 30, 2008 included pretax income of approximately \$8 million related to the favorable settlement of a prior year nursing center Medicaid cost report dispute.

Nursing center operating margins declined in the third quarter of 2009 and for the nine months ended September 30, 2009 compared to the same periods in 2008 as growth in labor and ancillary services costs exceeded revenue growth for both periods. Nursing center wage and benefit costs increased 3% to \$279 million in the third quarter of 2009 from \$271 million in the same period in 2008 and increased 3% to \$824 million for the nine months ended September 30, 2009 from \$798 million in the same period in 2008. Average hourly wage rates grew 2% in both the third quarter of 2009 and for the nine months ended September 30, 2009 compared to the respective prior year periods. Employee benefit costs increased 10% in the third quarter of 2009 and 9% for the nine months ended September 30, 2009 compared to the respective prior year periods, primarily as a result of increased employee health insurance costs.

Professional liability costs were \$7 million and \$2 million in the third quarter of 2009 and 2008, respectively, and \$23 million and \$18 million for the nine months ended September 30, 2009 and 2008, respectively.

***Rehabilitation division***

Revenues increased 15% in the third quarter of 2009 to \$123 million compared to \$106 million in the third quarter of 2008 and increased 14% to \$361 million for the nine months ended September 30, 2009 from \$317 million in the same period in 2008. The increase in revenues in both periods was primarily attributable to growth in new contracts and the volume of services provided to existing customers. Revenues derived from unaffiliated customers aggregated \$51 million and \$40 million in the third quarter of 2009 and 2008, respectively, and \$146 million and \$119 million for the nine months ended September 30, 2009 and 2008, respectively.

Operating margins in both the third quarter of 2009 and for the nine months ended September 30, 2009 increased primarily due to improvements in therapist productivity levels and the volume of services provided to existing customers.

***Corporate overhead***

Operating income for the Company's operating divisions excludes allocations of corporate overhead. These costs aggregated \$34 million and \$31 million in the third quarter of 2009 and 2008, respectively, and \$102 million and \$99 million for the nine months ended September 30, 2009 and 2008, respectively. As a percentage of consolidated revenues, corporate overhead totaled 3.2% and 3.1% in the third quarter of 2009 and 2008, respectively, and totaled 3.2% for both the nine months ended September 30, 2009 and 2008.

Corporate expenses included operating losses from the Company's limited purpose insurance subsidiary of \$2 million in the third quarter of both 2009 and 2008, and \$4 million and \$5 million for the nine months ended September 30, 2009 and 2008, respectively.

***Capital costs***

Rent expense increased 4% to \$88 million in the third quarter of 2009 compared to \$84 million in the third quarter of 2008 and increased 2% to \$260 million for the nine months ended September 30, 2009 from

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Results of Operations – Continuing Operations (Continued)**

*Capital costs (Continued)*

\$254 million in the same period in 2008. Rent expense for the nine months ended September 30, 2008 included a charge of approximately \$2 million related to a prior period rent escalator adjustment for ten leased facilities. The increase in both periods resulted primarily from contractual inflation and contingent rent increases.

Depreciation and amortization expense increased 10% in the third quarter of 2009 to \$32 million compared to \$29 million in the third quarter of 2008 and increased 4% to \$94 million for the nine months ended September 30, 2009 from \$90 million in the same period in 2008. The increase in both periods was primarily a result of the Company's ongoing capital expenditure program and hospital development.

Interest expense aggregated \$1 million and \$4 million in the third quarter of 2009 and 2008, respectively, and aggregated \$6 million and \$12 million for the nine months ended September 30, 2009 and 2008, respectively. The decline in both periods was primarily attributable to lower interest rates and lower borrowing levels under the Company's revolving credit facility compared to the same periods last year.

Investment income related primarily to the Company's insurance subsidiary investments totaled \$0.7 million in the third quarter of both 2009 and 2008, and totaled \$3 million and \$6 million for the nine months ended September 30, 2009 and 2008, respectively. The decline in the nine month period was primarily attributable to lower investment yields on the Company's insurance subsidiary's investment portfolio compared to the same period last year. The Company considered the unrealized losses related to its insurance subsidiary investments at September 30, 2009 to be temporary and did not record any impairment losses related to these investments in the third quarter or the nine months ended September 30, 2009.

Investment income was negatively impacted in the third quarter of 2008 by a \$1 million pretax other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio.

***Consolidated results***

Income from continuing operations before income taxes increased to \$6 million in the third quarter of 2009 compared to \$1 million in the third quarter of 2008 and increased 20% to \$76 million for the nine months ended September 30, 2009 from \$63 million in the same period in 2008. Income from continuing operations increased to \$5 million in the third quarter of 2009 compared to \$2 million in the third quarter of 2008 and increased 19% to \$46 million for the nine months ended September 30, 2009 from \$38 million in the same period in 2008.

**Results of Operations – Discontinued Operations**

Income from discontinued operations was breakeven in the third quarter of 2009 compared to a loss of

\$1 million in the third quarter of 2008, while loss from discontinued operations aggregated \$2 million and \$4 million for the nine months ended September 30, 2009 and 2008, respectively.

For the nine months ended September 30, 2009, the Company recorded a pretax loss of \$39 million (\$24 million net of income taxes) related to the planned divestiture of the Nursing Centers.

The Company recorded a pretax loss on divestiture of operations of \$36 million (\$22 million net of income taxes) during the third quarter of 2008 related to the planned divestiture of a LTAC hospital.

The Company recorded a pretax loss on divestiture of operations of \$31 million (\$19 million net of income taxes) during the nine months ended September 30, 2008.



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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Liquidity**

***Operating cash flows***

Cash flows provided by operations (including discontinued operations) aggregated \$140 million for the nine months ended September 30, 2009 compared to \$41 million for the same period in 2008. Operating cash flows for the nine months ended September 30, 2009 were favorably impacted by improved collections of accounts receivable. During both periods, the Company maintained sufficient liquidity to fund its ongoing capital expenditure program and finance ongoing hospital development expenditures as well as its acquisition and strategic divestiture activities.

Cash and cash equivalents totaled \$45 million at September 30, 2009 compared to \$141 million at December 31, 2008. The Company's long-term debt, comprised principally of borrowings under the Company's revolving credit facility, aggregated \$251 million at September 30, 2009 compared to \$350 million at December 31, 2008. Based upon the Company's existing cash levels, expected operating cash flows and the availability of borrowings under the Company's revolving credit facility, management believes that the Company has the necessary financial resources to satisfy its expected short-term and long-term liquidity needs.

***Strategic divestitures***

In June 2009, the Company purchased the Nursing Centers from Ventas for approximately \$56 million. In addition, the Company paid a lease termination fee of approximately \$2 million. The Nursing Centers were included in the Company's master lease agreements with Ventas and the Company does not have the ability to terminate a lease of an individual facility. The aggregate annual rent for the Nursing Centers was approximately \$6 million for the year ended December 31, 2008. The Nursing Centers, which contained 777 licensed beds, generated pretax losses of approximately \$3 million for the year ended December 31, 2008 and approximately \$2 million for the nine months ended September 30, 2009. The Company disposed of three of the Nursing Centers in September 2009 for \$14 million, which did not result in a gain or loss. The Company disposed of two of the Nursing Centers in October 2009 for approximately \$12 million, which will not result in a gain or loss. The Company intends to dispose of the remaining Nursing Center as soon as practicable and generate approximately \$1 million in net proceeds from the sale. The fair value of the Nursing Centers is classified as Level 3 in the fair value hierarchy.

In September 2008, the Company purchased for resale a LTAC hospital for approximately \$22 million that was previously leased and announced its intention to dispose of another LTAC hospital and its related operations. The Company intends to dispose of these two hospitals as soon as practicable and to generate approximately \$8 million in net proceeds from the sales.

During the nine months ended September 30, 2008, the Company sold seven nursing centers and one hospital for approximately \$28 million.

***Revolving credit facility and financing activities***

Under the terms of the Company's \$500 million revolving credit facility, the aggregate amount of the credit may be increased to \$600 million at the Company's option subject to lender approval and certain other conditions. If the Company elected to expand the available credit, the existing lenders are likely to demand new terms, including increases in the effective interest rate. The term of the Company's revolving credit facility expires in July 2012.

Interest rates under the Company's revolving credit facility are based, at the Company's option, upon (a) the London Interbank Offered Rate (LIBOR) plus the applicable margin or (b) the applicable margin plus the



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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Liquidity (Continued)**

***Revolving credit facility and financing activities (Continued)***

higher of the prime rate or 0.5% over the federal funds rate. The Company's revolving credit facility is collateralized by substantially all of the Company's assets including certain owned real property and is guaranteed by substantially all of the Company's subsidiaries. The terms of the Company's revolving credit facility include a certain defined fixed payment ratio covenant and covenants which limit acquisitions and annual capital expenditures. The Company was in compliance with the terms of its revolving credit facility at September 30, 2009.

Despite the recent turmoil within the financial markets both nationally and globally, the Company has not experienced any individual lender limitations to extend credit under its revolving credit facility. However, the obligations of each of the lending institutions in the Company's revolving credit facility are separate and the availability of future borrowings under the Company's revolving credit facility could be impacted by the ongoing volatility and disruptions in the financial credit markets or other events, including bankruptcy of a lending institution. The Company has maintained an excess cash position of approximately \$30 million at September 30, 2009 in the event that a lender is unable to extend credit under the Company's revolving credit facility.

In April 2009, the Company provided Ventas with notices to renew the master lease agreements for an additional five years for the Renewal Facilities. The initial lease term for the Renewal Facilities was scheduled to expire in April 2010. The Company's option to renew the leases on the Renewal Facilities would have expired on April 30, 2009. No additional rent or other consideration was paid in connection with these renewals. The effectiveness of the renewals is contingent upon there being no events of default under the master lease agreements in April 2010.

In May 2008, the Company received a cash distribution of \$7 million related to the sale of land by a partnership. The Company has a noncontrolling ownership interest in the partnership which is accounted for under the equity method of accounting. No gain or loss was recognized on the land sale.

In April 2008, the Company repaid a capital lease obligation of approximately \$16 million in connection with a purchase option under a hospital lease agreement.

The Company received distributions from its limited purpose insurance subsidiary of \$34 million and \$39 million during the nine months ended September 30, 2009 and 2008, respectively, as a result of improved professional liability underwriting results in prior years. These proceeds were used to repay borrowings under the Company's revolving credit facility and had no impact on earnings.

**Capital Resources**

Excluding acquisitions, capital expenditures totaled \$113 million for the nine months ended September 30, 2009 compared to \$112 million for the same period in 2008. Excluding acquisitions, routine capital expenditures could approximate \$110 million to \$115 million in 2009, while hospital development could approximate \$45 million to \$50 million in 2009. Management believes that its capital expenditure program is adequate to improve and equip existing facilities. The Company's capital expenditure program is financed generally through the use of internally generated funds. At September 30, 2009, the estimated cost to complete and equip construction in progress approximated \$30 million.

At September 30, 2009, the Company's remaining permitted acquisition amount under its revolving credit facility aggregated \$216 million.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**(Continued)**

**Capital Resources (Continued)**

In July 2009, the Company acquired a hospice business for \$8 million.

In March 2009, the Company acquired a previously leased hospital for approximately \$16 million in cash and approximately \$2 million in unamortized prepaid rent. Annual rent associated with this facility approximated \$2 million.

During the nine months ended September 30, 2008, the Company acquired four nursing centers that were previously leased for approximately \$24 million.

**Other Information**

*Effects of inflation and changing prices*

The Company derives a substantial portion of its revenues from the Medicare and Medicaid programs. Currently, Congress is considering various healthcare reforms that could materially impact the Medicare and Medicaid programs that could have a material adverse effect on the Company's business, financial position, results of operations and liquidity. These healthcare reforms also could negatively impact commercial insurance companies, which could negatively impact the rates the Company receives for providing services to commercial pay patients. In addition, Congress and certain state legislatures have enacted or may enact additional significant cost containment measures limiting the Company's ability to recover its cost increases through increased pricing of its healthcare services. Medicare revenues in LTAC hospitals and nursing centers are subject to fixed payments under the Medicare prospective payment systems.

Medicaid reimbursement rates in many states in which the Company operates nursing centers also are based upon fixed payment systems. Generally, these rates are adjusted annually for inflation. However, these adjustments may not reflect the actual increase in the costs of providing healthcare services. In addition, Medicaid reimbursement can be negatively impacted by state budgetary pressures.

LTAC PPS maintains LTAC hospitals as a distinct provider type, separate from short-term acute care hospitals. Only providers certified as LTAC hospitals may be paid under this system. To maintain certification under LTAC PPS, a hospital's average length of stay for Medicare patients must be at least 25 days.

CMS is currently evaluating various certification criteria for designating a hospital as a LTAC hospital. If such certification criteria were developed and enacted into legislation, the Company's hospitals may not be able to maintain their status as LTAC hospitals or may need to adjust their operations.

The SCHIP Extension Act became law on December 29, 2007. This legislation provides for, among other things:

- (1) a mandated study by the Secretary of Health and Human Services on the establishment of LTAC hospital certification criteria;
- (2) enhanced medical necessity review of LTAC hospital cases;
- (3) a three-year moratorium on the establishment of a LTAC hospital or satellite facility, subject to exceptions for facilities under development;
- (4)

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a three-year moratorium on an increase in the number of licensed beds at a LTAC hospital or satellite facility, subject to exceptions for states where there is only one other LTAC hospital and upon request following the closure or decrease in the number of licensed beds at a LTAC hospital within the state;

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Other Information (Continued)**

*Effects of inflation and changing prices (Continued)*

- (5) a three-year moratorium on the application of a one-time budget neutrality adjustment to payment rates to LTAC hospitals under LTAC PPS;
- (6) a three-year moratorium on very short-stay outlier payment reductions to LTAC hospitals initially implemented on May 1, 2007;
- (7) a three-year moratorium on the application of the so-called 25 Percent Rule to freestanding LTAC hospitals;
- (8) a three-year period during which LTAC hospitals that are co-located with another hospital may admit up to 50% of their patients from their host hospitals and still be paid according to LTAC PPS;
- (9) a three-year period during which LTAC hospitals that are co-located with an urban single hospital or a hospital that generates more than 25% of the Medicare discharges in a metropolitan statistical area (MSA Dominant hospital) may admit up to 75% of their patients from such urban single hospital or MSA Dominant hospital and still be paid according to LTAC PPS; and
- (10) the elimination of the July 1, 2007 market basket increase in the standard federal payment rate of 0.71%, effective for discharges occurring on or after April 1, 2008.

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2007 Final Rule) that became effective for discharges occurring on or after July 1, 2007. The 2007 Final Rule was amended on June 29, 2007 by revising the high cost outlier threshold. The 2007 Final Rule projected an overall decrease in payments to all Medicare certified LTAC hospitals of approximately 1.2%. Included in the 2007 Final Rule were (1) an increase to the standard federal payment rate of 0.71% (which was eliminated for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act); (2) revisions to payment methodologies impacting short-stay outliers, which reduce payments by 0.9% (currently subject to a three-year moratorium pursuant to the SCHIP Extension Act); (3) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.5%; (4) an increase in the high cost outlier threshold per discharge to \$20,707, resulting in projected reductions of 0.4%; and (5) an extension of the policy known as the 25 Percent Rule to all LTAC hospitals, with a three-year phase-in, which CMS projected would not result in payment reductions for the first year of implementation (also currently subject to a three-year moratorium pursuant to the SCHIP Extension Act).

In the 2007 Final Rule, the so-called 25 Percent Rule was expanded to all LTAC hospitals, regardless of whether they are co-located with another hospital. Under the 2007 Final Rule, all LTAC hospitals were to be paid the LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Patients reaching high cost outlier status in the short-term hospital were not to be counted when computing the 25% limit. Admissions beyond the 25% threshold were to be paid at a lower amount based upon short-term acute care hospital rates. However, as set forth above, the SCHIP Extension Act has placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. In addition, the SCHIP Extension Act provides for a three-year period during which (1) LTAC hospitals that are co-located with another hospital may admit up to 50% of their patients from their host hospitals and still be paid according to LTAC PPS, and (2) LTAC hospitals that are co-located with an urban single hospital or a MSA Dominant hospital may admit up to 75% of their patients from such urban single or MSA Dominant hospital and still be paid according to LTAC PPS.

On May 2, 2008, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2008 Final Rule) that became effective for discharges occurring on or after July 1, 2008. The 2008 Final Rule projected an overall increase in payments to all Medicare certified LTAC hospitals of approximately 2.5%.



**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Other Information (Continued)***Effects of inflation and changing prices (Continued)*

Included in the 2008 Final Rule were (1) an increase to the standard federal payment rate of 2.7% (as compared to the adjusted federal rate for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act); (2) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.1%; (3) an increase in the high cost outlier threshold per discharge to \$22,960; and (4) an extension of the rate year cycle for one year to September 30, 2009, in order to be consistent thereafter with the federal fiscal year that begins October 1 of each year.

CMS has regulations governing payments to LTAC hospitals that are co-located with another hospital, such as a hospital-in-hospital ( HIH ). The rules generally limit Medicare payments to the HIH if the Medicare admissions to the HIH from the host hospital exceed 25% of the total Medicare discharges for the HIH's cost reporting period. There are limited exceptions for admissions from rural, urban single and MSA Dominant hospitals. Admissions that exceed this 25 Percent Rule are paid using the short-term acute care inpatient payment system ( IPPS ). Patients transferred after they have reached the short-term acute care outlier payment status are not counted toward the admission threshold. Patients admitted prior to meeting the admission threshold, as well as Medicare patients admitted from a non-host hospital, are eligible for the full payment under LTAC PPS. If the HIH's admissions from the host hospital exceed the limit in a cost reporting period, Medicare will pay the lesser of (1) the amount payable under LTAC PPS or (2) the amount payable under IPPS. At September 30, 2009, the Company operated 16 HIHs with 692 licensed beds.

On August 1, 2007, CMS issued final regulations regarding Medicare hospital inpatient payments to short-term acute care hospitals as well as certain provisions affecting LTAC hospitals. These regulations adopt a new system for classifying patients into diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, MS-LTC-DRGs. LTAC PPS is based upon discharged-based MS-LTC-DRGs similar to the system used to pay short-term acute care hospitals. This new MS-LTC-DRG system replaces the previous diagnostic related group system for LTAC hospitals and became effective for discharges occurring on or after October 1, 2007. The MS-LTC-DRG system creates additional severity-adjusted categories for most diagnoses, resulting in an expansion of the aggregate number of diagnostic groups from 538 to 745. CMS stated that MS-LTC-DRG weights were developed in a budget neutral manner and as such, the estimated aggregate payments under LTAC PPS would be unaffected by the annual recalibration of MS-LTC-DRG payment weights.

On July 31, 2008, CMS issued final regulations regarding the re-weighting of MS-LTC-DRGs for discharges occurring on or after October 1, 2008. CMS announced that this update was made in a budget neutral manner, and that estimated aggregate LTAC Medicare payments would be unaffected by these regulations. Based upon the Company's experience under these final regulations, it appears that the re-weighting increased payments for the care of higher acuity patients. On May 29, 2009, CMS issued an interim final rule that revised the October 1, 2008 payment weights. Effective June 3, 2009, CMS reduced MS-LTC-DRG payment weights by 3.9%, resulting in approximately a 0.9% reduction of the estimated total LTAC PPS payments in the federal fiscal year ending September 30, 2009. No retroactive adjustments to payments were made. On July 31, 2009, CMS finalized this interim rule without changes.

On July 31, 2009, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2009. These final regulations include a recalibration of the MS-LTC-DRG payment weights as well as updates to the payment rates. CMS indicated that these changes will result in a 3.3% increase to average Medicare payments to LTAC hospitals. The reductions that resulted from a recalibration of MS-LTC-DRG payment weights on June 3, 2009 are incorporated into the final October 1, 2009 payment weights.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)**

**Other Information (Continued)**

*Effects of inflation and changing prices (Continued)*

The Company cannot predict the ultimate long-term impact of LTAC PPS. This payment system is subject to significant change. Slight variations in patient acuity or length of stay could significantly change Medicare revenues generated under LTAC PPS. In addition, the Company's hospitals may not be able to appropriately adjust their operating costs to changes in patient acuity and length of stay or to changes in reimbursement rates. In addition, there can be no assurance that LTAC PPS will not have a material adverse effect on revenues from non-government third party payors. Various factors, including a reduction in average length of stay, have negatively impacted revenues from non-government third party payors in recent years.

On July 31, 2008, CMS issued final regulations regarding Medicare reimbursement for nursing centers for the fiscal year beginning October 1, 2008. These regulations included, among other things, a market basket increase to the federal payment rates of 3.4% and updates to the wage indexes which adjust the federal payment. CMS estimates that the overall impact of these proposed changes will be a net increase in payments of 3.4%.

On July 31, 2009, CMS issued final regulations regarding Medicare reimbursement for nursing centers for the fiscal year beginning October 1, 2009. Included in these regulations are (1) a market basket increase to the federal payment rates of 2.2%, (2) updates to the wage indexes which adjust the federal payment, and (3) a reduction in the resource utilization grouping (RUG) indexes attributed to a CMS forecast error in a prior year, resulting in a 3.3% reduction in payments. CMS estimated that these changes will result in a net decrease in Medicare payments to nursing centers of 1.1%.

In addition, for the fiscal year beginning October 1, 2010, CMS will increase the number of RUG categories for nursing centers from 53 to 66 and amend the criteria, including the provision of therapy services, currently used to classify patients into these categories. CMS has indicated that these changes will be enacted in a budget neutral manner. While the Company is unable to estimate the impact of these changes, the operating results of its contract rehabilitation services business may be adversely affected.

On February 1, 2006, Congress passed the Deficit Reduction Act of 2005. This legislation provided for, among other things, an annual \$1,740 Medicare Part B outpatient therapy cap that was effective on January 1, 2006. CMS subsequently increased the therapy cap to \$1,780 on January 1, 2007, to \$1,810 on January 1, 2008 and to \$1,840 on January 1, 2009. The legislation also required CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. The exception process, which was set to expire on January 1, 2007, was included in the Tax Relief and Health Care Act of 2006 and continued to function as an exception to the Medicare Part B outpatient therapy cap until January 1, 2008. The SCHIP Extension Act further extended the Medicare Part B outpatient therapy cap until June 30, 2008. The Medicare Improvements for Patients and Providers Act of 2008, enacted on July 15, 2008, extended the therapy cap exception process from July 1, 2008 to December 31, 2009.

The Company believes that its operating margins may continue to be under pressure because of deterioration in pricing flexibility, changes in payor mix, changes in length of stay and growth in operating expenses in excess of increases in payments by third party payors. In addition, as a result of competitive pressures, the Company's ability to maintain operating margins through price increases to private patients is limited.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Condensed Consolidated Statement of Operations****(Unaudited)****(In thousands, except per share amounts)**

|   | 2008 Quarters |              |             |              | 2009 Quarters |              |              |
|---|---------------|--------------|-------------|--------------|---------------|--------------|--------------|
|   | First         | Second       | Third       | Fourth       | First         | Second       | Third        |
| Revenues  | \$ 1,034,475  | \$ 1,026,041 | \$ 997,129  | \$ 1,036,219 | \$ 1,069,474  | \$ 1,073,054 | \$ 1,057,488 |
| Salaries, wages and benefits                          | 592,240       | 587,416      | 597,216     | 597,291      | 615,218       | 620,830      | 629,077      |
| Supplies  | 77,834        | 80,769       | 77,766      | 80,780       | 80,336        | 83,912       | 82,400       |
| Rent  | 83,623        | 85,860       | 84,865      | 84,325       | 85,201        | 86,882       | 88,081       |
| Other operating expenses                              | 223,973       | 213,544      | 207,773     | 209,093      | 220,405       | 221,755      | 221,524      |
| Other income  | (4,717)       | (5,167)      | (4,313)     | (3,210)      | (2,872)       | (2,823)      | (2,870)      |
| Depreciation and amortization                         | 30,558        | 30,545       | 29,174      | 29,745       | 30,490        | 31,355       | 31,992       |
| Interest expense                                      | 4,921         | 2,907        | 3,710       | 3,835        | 2,478         | 2,229        | 1,741        |
| Investment income                                     | (3,247)       | (2,335)      | (671)       | (843)        | (1,475)       | (1,033)      | (746)        |
|   | 1,005,185     | 993,539      | 995,520     | 1,001,016    | 1,029,781     | 1,043,107    | 1,051,199    |
| Income from continuing operations before income taxes | 29,290        | 32,502       | 1,609       | 35,203       | 39,693        | 29,947       | 6,289        |
| Provision (benefit) for income taxes                  | 12,080        | 13,025       | (510)       | 13,549       | 16,352        | 12,409       | 901          |
| Income from continuing operations                     | 17,210        | 19,477       | 2,119       | 21,654       | 23,341        | 17,538       | 5,388        |
| Discontinued operations, net of income taxes:         |               |              |             |              |               |              |              |
| Income (loss) from operations                         | (2,520)       | (528)        | (1,321)     | 970          | (581)         | (897)        | 13           |
| Gain (loss) on divestiture of operations              |               | 2,712        | (22,058)    | (1,430)      |               | (24,051)     | 52           |
| Net income (loss)                                     | \$ 14,690     | \$ 21,661    | \$ (21,260) | \$ 21,194    | \$ 22,760     | \$ (7,410)   | \$ 5,453     |
| Earnings (loss) per common share:                     |               |              |             |              |               |              |              |
| Basic:  |               |              |             |              |               |              |              |
| Income from continuing operations                     | \$ 0.45       | \$ 0.50      | \$ 0.05     | \$ 0.56      | \$ 0.60       | \$ 0.45      | \$ 0.14      |
| Discontinued operations:                              |               |              |             |              |               |              |              |
| Income (loss) from operations                         | (0.07)        | (0.01)       | (0.03)      | 0.02         | (0.02)        | (0.02)       |              |
| Gain (loss) on divestiture of operations              |               | 0.07         | (0.57)      | (0.04)       |               | (0.62)       |              |
| Net income (loss)                                     | \$ 0.38       | \$ 0.56      | \$ (0.55)   | \$ 0.54      | \$ 0.58       | \$ (0.19)    | \$ 0.14      |
| Diluted:  |               |              |             |              |               |              |              |
| Income from continuing operations                     | \$ 0.44       | \$ 0.49      | \$ 0.05     | \$ 0.55      | \$ 0.60       | \$ 0.45      | \$ 0.14      |
| Discontinued operations:                              |               |              |             |              |               |              |              |
| Income (loss) from operations                         | (0.06)        | (0.01)       | (0.03)      | 0.03         | (0.02)        | (0.02)       |              |



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|  |    |        |        |        |        |        |    |        |    |        |    |        |    |        |
|--|----|--------|--------|--------|--------|--------|----|--------|----|--------|----|--------|----|--------|
| Gain (loss) on divestiture of operations                   |    | 0.07   | (0.56) | (0.04) | (0.62) |        |    |        |    |        |    |        |    |        |
| Net income (loss)  | \$ | 0.38   | \$     | 0.55   | \$     | (0.54) | \$ | 0.54   | \$ | 0.58   | \$ | (0.19) | \$ | 0.14   |
| Shares used in computing earnings (loss) per common share: |    |        |        |        |        |        |    |        |    |        |    |        |    |        |
| Basic  |    | 37,444 |        | 37,714 |        | 38,034 |    | 38,123 |    | 38,184 |    | 38,307 |    | 38,398 |
| Diluted  |    | 38,061 |        | 38,474 |        | 38,894 |    | 38,265 |    | 38,315 |    | 38,415 |    | 38,524 |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
(Continued)**Operating Data**

(Unaudited)

(In thousands)

|   | 2008 Quarters |              |            |              | 2009 Quarters |              |              |
|---|---------------|--------------|------------|--------------|---------------|--------------|--------------|
|   | First         | Second       | Third      | Fourth       | First         | Second       | Third        |
| <b>Revenues:</b>                                      |               |              |            |              |               |              |              |
| Hospital division                                     | \$ 476,167    | \$ 461,064   | \$ 434,774 | \$ 465,317   | \$ 492,509    | \$ 487,145   | \$ 468,069   |
| Health services division                              | 519,543       | 525,162      | 521,074    | 527,518      | 529,942       | 537,545      | 539,217      |
| Rehabilitation division                               | 104,499       | 106,318      | 106,796    | 109,707      | 117,647       | 120,450      | 122,625      |
|   | 1,100,209     | 1,092,544    | 1,062,644  | 1,102,542    | 1,140,098     | 1,145,140    | 1,129,911    |
| Eliminations  | (65,734)      | (66,503)     | (65,515)   | (66,323)     | (70,624)      | (72,086)     | (72,423)     |
|   | \$ 1,034,475  | \$ 1,026,041 | \$ 997,129 | \$ 1,036,219 | \$ 1,069,474  | \$ 1,073,054 | \$ 1,057,488 |
| <b>Income from continuing operations:</b>             |               |              |            |              |               |              |              |
| Operating income (loss):                              |               |              |            |              |               |              |              |
| Hospital division                                     | \$ 96,802     | \$ 85,886    | \$ 64,818  | \$ 97,861    | \$ 100,899    | \$ 91,027    | \$ 78,674    |
| Health services division                              | 73,291        | 87,962       | 79,133     | 81,428       | 75,574        | 79,522       | 73,383       |
| Rehabilitation division                               | 11,486        | 10,178       | 7,448      | 8,959        | 15,453        | 13,599       | 10,912       |
| Corporate:  |               |              |            |              |               |              |              |
| Overhead  | (34,931)      | (33,200)     | (30,937)   | (33,951)     | (34,087)      | (33,586)     | (33,843)     |
| Insurance subsidiary                                  | (1,503)       | (1,347)      | (1,775)    | (2,032)      | (1,452)       | (1,182)      | (1,769)      |
|   | (36,434)      | (34,547)     | (32,712)   | (35,983)     | (35,539)      | (34,768)     | (35,612)     |
| Operating income                                      | 145,145       | 149,479      | 118,687    | 152,265      | 156,387       | 149,380      | 127,357      |
| Rent  | (83,623)      | (85,860)     | (84,865)   | (84,325)     | (85,201)      | (86,882)     | (88,081)     |
| Depreciation and amortization                         | (30,558)      | (30,545)     | (29,174)   | (29,745)     | (30,490)      | (31,355)     | (31,992)     |
| Interest, net   | (1,674)       | (572)        | (3,039)    | (2,992)      | (1,003)       | (1,196)      | (995)        |
| Income from continuing operations before income taxes | 29,290        | 32,502       | 1,609      | 35,203       | 39,693        | 29,947       | 6,289        |
| Provision (benefit) for income taxes                  | 12,080        | 13,025       | (510)      | 13,549       | 16,352        | 12,409       | 901          |
|   | \$ 17,210     | \$ 19,477    | \$ 2,119   | \$ 21,654    | \$ 23,341     | \$ 17,538    | \$ 5,388     |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Operating Data (Continued)****(Unaudited)****(In thousands)**

|  | 2008 Quarters |           |           |           | 2009 Quarters |           |           |
|--|---------------|-----------|-----------|-----------|---------------|-----------|-----------|
|  | First         | Second    | Third     | Fourth    | First         | Second    | Third     |
| <b>Rent:</b>   |               |           |           |           |               |           |           |
| Hospital division  | \$ 35,907     | \$ 37,750 | \$ 36,461 | \$ 36,198 | \$ 36,445     | \$ 36,834 | \$ 37,062 |
| Health services division   | 46,326        | 46,611    | 46,972    | 46,703    | 47,274        | 48,565    | 49,471    |
| Rehabilitation division  | 1,358         | 1,393     | 1,405     | 1,399     | 1,451         | 1,459     | 1,495     |
| Corporate  | 32            | 106       | 27        | 25        | 31            | 24        | 53        |
|  | \$ 83,623     | \$ 85,860 | \$ 84,865 | \$ 84,325 | \$ 85,201     | \$ 86,882 | \$ 88,081 |
| <b>Depreciation and amortization:</b>  |               |           |           |           |               |           |           |
| Hospital division  | \$ 11,303     | \$ 11,455 | \$ 11,719 | \$ 13,673 | \$ 12,512     | \$ 13,018 | \$ 13,275 |
| Health services division   | 13,892        | 13,292    | 11,536    | 9,925     | 11,685        | 12,038    | 12,408    |
| Rehabilitation division  | 387           | 485       | 547       | 546       | 547           | 549       | 584       |
| Corporate  | 4,976         | 5,313     | 5,372     | 5,601     | 5,746         | 5,750     | 5,725     |
|  | \$ 30,558     | \$ 30,545 | \$ 29,174 | \$ 29,745 | \$ 30,490     | \$ 31,355 | \$ 31,992 |
| <b>Capital expenditures, excluding acquisitions (including discontinued operations):</b> |               |           |           |           |               |           |           |
| Hospital division  | \$ 13,556     | \$ 20,022 | \$ 19,736 | \$ 15,903 | \$ 14,330     | \$ 17,730 | \$ 21,110 |
| Health services division   | 7,135         | 10,744    | 19,746    | 12,468    | 21,840        | 11,946    | 6,371     |
| Rehabilitation division  | 282           | 280       | 271       | 329       | 190           | 172       | 269       |
| Corporate:   |               |           |           |           |               |           |           |
| Information systems  | 3,832         | 8,616     | 7,051     | 6,864     | 3,453         | 8,838     | 6,152     |
| Other  | 135           | 258       | 489       | 960       | 173           | 210       | 73        |
|  | \$ 24,940     | \$ 39,920 | \$ 47,293 | \$ 36,524 | \$ 39,986     | \$ 38,896 | \$ 33,975 |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Operating Data (Continued)****(Unaudited)**

|                                | 2008 Quarters |           |           |           | 2009 Quarters |           |           |
|--------------------------------|---------------|-----------|-----------|-----------|---------------|-----------|-----------|
|                                | First         | Second    | Third     | Fourth    | First         | Second    | Third     |
| <b>Hospital data:</b>          |               |           |           |           |               |           |           |
| End of period data:            |               |           |           |           |               |           |           |
| Number of hospitals            | 81            | 81        | 82        | 82        | 82            | 82        | 82        |
| Number of licensed beds        | 6,358         | 6,358     | 6,428     | 6,482     | 6,520         | 6,520     | 6,520     |
| Revenue mix %:                 |               |           |           |           |               |           |           |
| Medicare                       | 57            | 56        | 54        | 55        | 56            | 55        | 55        |
| Medicaid                       | 9             | 9         | 11        | 11        | 10            | 10        | 11        |
| Medicare Advantage             | 8             | 9         | 9         | 10        | 10            | 11        | 9         |
| Commercial insurance and other | 26            | 26        | 26        | 24        | 24            | 24        | 25        |
| Admissions:                    |               |           |           |           |               |           |           |
| Medicare                       | 7,920         | 7,268     | 6,786     | 7,054     | 7,421         | 7,117     | 6,875     |
| Medicaid                       | 1,034         | 1,008     | 1,148     | 1,043     | 1,052         | 1,053     | 1,165     |
| Medicare Advantage             | 901           | 849       | 869       | 968       | 1,094         | 1,091     | 926       |
| Commercial insurance and other | 1,814         | 1,799     | 1,748     | 1,727     | 1,921         | 1,869     | 1,969     |
|                                | 11,669        | 10,924    | 10,551    | 10,792    | 11,488        | 11,130    | 10,935    |
| Admissions mix %:              |               |           |           |           |               |           |           |
| Medicare                       | 68            | 67        | 64        | 65        | 65            | 64        | 63        |
| Medicaid                       | 9             | 9         | 11        | 10        | 9             | 9         | 11        |
| Medicare Advantage             | 8             | 8         | 8         | 9         | 9             | 10        | 8         |
| Commercial insurance and other | 15            | 16        | 17        | 16        | 17            | 17        | 18        |
| Patient days:                  |               |           |           |           |               |           |           |
| Medicare                       | 216,737       | 210,064   | 188,832   | 190,794   | 197,377       | 197,203   | 188,712   |
| Medicaid                       | 50,335        | 50,676    | 54,108    | 53,304    | 50,868        | 50,485    | 53,585    |
| Medicare Advantage             | 28,453        | 29,219    | 28,529    | 31,744    | 35,229        | 36,806    | 29,912    |
| Commercial insurance and other | 66,270        | 67,847    | 64,449    | 63,688    | 65,509        | 61,960    | 65,717    |
|                                | 361,795       | 357,806   | 335,918   | 339,530   | 348,983       | 346,454   | 337,926   |
| Average length of stay:        |               |           |           |           |               |           |           |
| Medicare                       | 27.4          | 28.9      | 27.8      | 27.0      | 26.6          | 27.7      | 27.4      |
| Medicaid                       | 48.7          | 50.3      | 47.1      | 51.1      | 48.4          | 47.9      | 46.0      |
| Medicare Advantage             | 31.6          | 34.4      | 32.8      | 32.8      | 32.2          | 33.7      | 32.3      |
| Commercial insurance and other | 36.5          | 37.7      | 36.9      | 36.9      | 34.1          | 33.2      | 33.4      |
| Weighted average               | 31.0          | 32.8      | 31.8      | 31.5      | 30.4          | 31.1      | 30.9      |
| Revenues per admission:        |               |           |           |           |               |           |           |
| Medicare                       | \$ 34,128     | \$ 35,717 | \$ 34,721 | \$ 36,029 | \$ 37,262     | \$ 37,748 | \$ 37,105 |
| Medicaid                       | 41,853        | 42,271    | 40,798    | 50,577    | 45,160        | 45,759    | 43,640    |
| Medicare Advantage             | 42,167        | 46,448    | 45,679    | 46,305    | 46,387        | 46,950    | 47,597    |
| Commercial insurance and other | 68,691        | 66,385    | 64,431    | 65,774    | 61,286        | 63,716    | 59,957    |

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|  |          |          |          |          |          |          |          |
|--|----------|----------|----------|----------|----------|----------|----------|
| Weighted average                                   | 40,806   | 42,206   | 41,207   | 43,117   | 42,872   | 43,769   | 42,805   |
| Revenues per patient day:                          |          |          |          |          |          |          |          |
| Medicare   | \$ 1,247 | \$ 1,236 | \$ 1,248 | \$ 1,332 | \$ 1,401 | \$ 1,362 | \$ 1,352 |
| Medicaid   | 860      | 841      | 866      | 990      | 934      | 954      | 949      |
| Medicare Advantage                                 | 1,335    | 1,350    | 1,391    | 1,412    | 1,440    | 1,392    | 1,473    |
| Commercial insurance and other                     | 1,880    | 1,760    | 1,748    | 1,784    | 1,797    | 1,922    | 1,796    |
| Weighted average                                   | 1,316    | 1,289    | 1,294    | 1,370    | 1,411    | 1,406    | 1,385    |
| Medicare case mix index (discharged patients only) | 1.12     | 1.16     | 1.14     | 1.17     | 1.22     | 1.23     | 1.19     |
| Average daily census                               | 3,976    | 3,932    | 3,651    | 3,691    | 3,878    | 3,807    | 3,673    |
| Occupancy %  | 67.9     | 67.1     | 62.2     | 62.1     | 66.0     | 64.7     | 63.6     |
| Annualized employee turnover %                     | 25.0     | 25.9     | 25.7     | 25.2     | 21.3     | 22.1     | 22.8     |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Operating Data (Continued)****(Unaudited)**

|   | 2008 Quarters |           |           |           | 2009 Quarters |           |           |
|---|---------------|-----------|-----------|-----------|---------------|-----------|-----------|
|   | First         | Second    | Third     | Fourth    | First         | Second    | Third     |
| <b>Nursing center data:</b>                 |               |           |           |           |               |           |           |
| End of period data:                         |               |           |           |           |               |           |           |
| Number of nursing centers:                  |               |           |           |           |               |           |           |
| Owned or leased                             | 218           | 218       | 218       | 218       | 218           | 218       | 218       |
| Managed                                     | 4             | 4         | 4         | 4         | 4             | 4         | 4         |
|   | 222           | 222       | 222       | 222       | 222           | 222       | 222       |
| Number of licensed beds:                    |               |           |           |           |               |           |           |
| Owned or leased                             | 27,569        | 27,449    | 27,422    | 27,252    | 27,138        | 27,138    | 27,086    |
| Managed                                     | 485           | 485       | 485       | 485       | 485           | 485       | 485       |
|   | 28,054        | 27,934    | 27,907    | 27,737    | 27,623        | 27,623    | 27,571    |
| Revenue mix %:                              |               |           |           |           |               |           |           |
| Medicare                                    | 35            | 35        | 33        | 34        | 35            | 35        | 34        |
| Medicaid                                    | 42            | 43        | 43        | 43        | 41            | 41        | 42        |
| Medicare Advantage                          | 5             | 5         | 5         | 5         | 6             | 6         | 6         |
| Private and other                           | 18            | 17        | 19        | 18        | 18            | 18        | 18        |
| Patient days (excludes managed facilities): |               |           |           |           |               |           |           |
| Medicare                                    | 401,468       | 394,520   | 365,125   | 361,977   | 374,853       | 375,140   | 360,009   |
| Medicaid                                    | 1,356,401     | 1,347,763 | 1,387,819 | 1,374,670 | 1,326,654     | 1,323,157 | 1,357,596 |
| Medicare Advantage                          | 64,929        | 68,850    | 69,655    | 69,083    | 80,352        | 82,652    | 84,322    |
| Private and other                           | 413,510       | 406,564   | 419,071   | 420,193   | 403,320       | 415,510   | 415,467   |
|   | 2,236,308     | 2,217,697 | 2,241,670 | 2,225,923 | 2,185,179     | 2,196,459 | 2,217,394 |
| Patient day mix %:                          |               |           |           |           |               |           |           |
| Medicare                                    | 18            | 18        | 16        | 16        | 17            | 17        | 16        |
| Medicaid                                    | 61            | 61        | 62        | 62        | 61            | 60        | 61        |
| Medicare Advantage                          | 3             | 3         | 3         | 3         | 4             | 4         | 4         |
| Private and other                           | 18            | 18        | 19        | 19        | 18            | 19        | 19        |
| Revenues per patient day:                   |               |           |           |           |               |           |           |
| Medicare Part A                             | \$ 428        | \$ 430    | \$ 433    | \$ 455    | \$ 457        | \$ 459    | \$ 464    |
| Total Medicare (including Part B)           | 461           | 465       | 474       | 497       | 497           | 500       | 508       |
| Medicaid                                    | 159           | 166       | 163       | 163       | 165           | 167       | 166       |
| Medicare Advantage                          | 369           | 373       | 370       | 381       | 380           | 392       | 398       |
| Private and other                           | 229           | 227       | 230       | 231       | 235           | 232       | 234       |
| Weighted average                            | 232           | 237       | 232       | 237       | 243           | 245       | 243       |

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|                                 |        |        |        |        |        |        |        |
|---------------------------------|--------|--------|--------|--------|--------|--------|--------|
| Average daily census            | 24,575 | 24,370 | 24,366 | 24,195 | 24,280 | 24,137 | 24,102 |
| Admissions                      | 18,215 | 17,634 | 16,903 | 17,234 | 18,166 | 18,456 | 17,803 |
| Occupancy %                     | 89.3   | 89.1   | 89.2   | 88.9   | 89.3   | 88.9   | 88.9   |
| Medicare average length of stay | 35.2   | 35.7   | 36.5   | 34.8   | 34.8   | 35.5   | 36.3   |
| Annualized employee turnover %  | 48.2   | 50.2   | 51.0   | 48.9   | 37.9   | 39.9   | 40.2   |

**Rehabilitation data:**

|                                      |            |            |            |            |            |            |            |
|--------------------------------------|------------|------------|------------|------------|------------|------------|------------|
| Revenue mix %:                       |            |            |            |            |            |            |            |
| Company-operated                     | 65         | 64         | 62         | 61         | 61         | 60         | 59         |
| Non-affiliated                       | 35         | 36         | 38         | 39         | 39         | 40         | 41         |
| Sites of services (at end of period) | 650        | 658        | 659        | 655        | 661        | 659        | 660        |
| Revenue per site                     | \$ 160,767 | \$ 161,578 | \$ 162,058 | \$ 167,492 | \$ 177,984 | \$ 182,775 | \$ 185,797 |
| Therapist productivity %             | 81.9       | 81.3       | 80.1       | 82.3       | 84.8       | 84.8       | 83.5       |
| Annualized employee turnover %       | 13.1       | 13.5       | 13.2       | 13.3       | 10.9       | 11.6       | 13.1       |

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The following discussion of the Company's exposure to market risk contains forward-looking statements that involve risks and uncertainties. Given the unpredictability of interest rates as well as other factors, actual results could differ materially from those projected in such forward-looking information.

The Company's exposure to market risk relates to changes in the prime rate, federal funds rate and LIBOR which affect the interest paid on certain borrowings.

The following table provides information about the Company's financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted average interest rates by expected maturity date.

**Interest Rate Sensitivity****Principal Amount by Expected Maturity****Average Interest Rate****(Dollars in thousands)**

|  | Expected maturities |       |       |            |        |            | Total      | Fair value<br>9/30/09 |
|--|---------------------|-------|-------|------------|--------|------------|------------|-----------------------|
|  | 2009                | 2010  | 2011  | 2012       | 2013   | Thereafter |            |                       |
| <b>Liabilities:</b>                                    |                     |       |       |            |        |            |            |                       |
| Long-term debt, including amounts due within one year: |                     |       |       |            |        |            |            |                       |
| Fixed rate   | \$ 21               | \$ 86 | \$ 91 | \$ 96      | \$ 102 | \$ 358     | \$ 754     | \$ 713(a)             |
| Average interest rate                                  | 6.0%                | 6.0%  | 6.0%  | 6.0%       | 6.0%   | 6.0%       |            |                       |
| Variable rate (b)                                      | \$                  | \$    | \$    | \$ 250,400 | \$     | \$         | \$ 250,400 | \$ 250,400            |

- (a) Calculated based upon the net present value of future principal and interest payments using a discount rate of 6%.
- (b) Interest on borrowings under the Company's revolving credit facility is payable, at the Company's option, at (1) LIBOR plus an applicable margin ranging from 1.25% to 2.00% or (2) the applicable margin ranging from 0.25% to 1.00% plus the higher of the prime rate or 0.5% over the federal funds rate. The applicable margin is based upon the Company's average daily excess availability as defined in the Company's revolving credit facility.



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**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures and Changes in Internal Control Over Financial Reporting**

The Company has carried out an evaluation under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2009, the Company's disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that the Company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

There has been no change in the Company's internal control over financial reporting during the Company's quarter ended September 30, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. These legal actions and investigations could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The DOJ, CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company's businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company's business, financial position, results of operations and liquidity.

**Item 6. Exhibits**

- 31 Rule 13a-14(a)/15d-14(a) Certifications.
- 32 Section 1350 Certifications.

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**SIGNATURES**

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

**KINDRED HEALTHCARE, INC.**

Date: November 6, 2009

/s/ PAUL J. DIAZ  
**Paul J. Diaz**  
**President and**  
**Chief Executive Officer**

Date: November 6, 2009

/s/ RICHARD A. LECHLEITER  
**Richard A. Lechleiter**  
**Executive Vice President and**  
**Chief Financial Officer**