KINDRED HEALTHCARE, INC
Form 10-Q
August 09, 2011
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

# FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended June 30, 2011**

**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 | 61-1323993 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 680 South Fourth Street | 40202-2412 |
| Louisville, KY | |
| (Address of principal executive offices) | (Zip Code) |

(502) 596-7300

(Registrant s telephone number, including area 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 to such filing requirements for the past 90 days. Yes þ 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 þ 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 þ |
| 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 þ

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

| Class of Common Stock | Outstanding at July 31, 2011 |
|---|---|
| Common stock, $0.25 par value | 52,112,586 shares |

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**KINDRED HEALTHCARE, INC.**

**CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS**

**(Unaudited)**

**(In thousands, except per share amounts)**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Revenues | $ 1,292,592 | $ 1,081,364 | $ 2,485,013 | $ 2,171,201 |
| Salaries, wages and benefits | 765,133 | 612,205 | 1,443,828 | 1,239,380 |
| Supplies | 96,718 | 85,455 | 186,740 | 171,341 |
| Rent | 95,677 | 88,981 | 187,130 | 177,300 |
| Other operating expenses | 287,132 | 238,687 | 546,501 | 472,891 |
| Other income | (2,880) | (2,857) | (5,665) | (5,941) |
| Depreciation and amortization | 37,871 | 29,852 | 70,420 | 60,973 |
| Interest expense | 23,157 | 1,298 | 28,885 | 2,605 |
| Investment (income) loss | (257) | 377 | (752) | (500) |
| | 1,302,551 | 1,053,998 | 2,457,087 | 2,118,049 |
| Income (loss) from continuing operations before income taxes | (9,959) | 27,366 | 27,926 | 53,152 |
| Provision (benefit) for income taxes | (3,419) | 11,230 | 12,190 | 21,861 |
| Income (loss) from continuing operations | (6,540) | 16,136 | 15,736 | 31,291 |
| Discontinued operations, net of income taxes: | | | | |
| Income (loss) from operations | 587 | 87 | 408 | (67) |
| Gain (loss) on divestiture of operations | | 54 | | (83) |
| Income (loss) from discontinued operations | 587 | 141 | 408 | (150) |
| Net income (loss) | (5,953) | 16,277 | 16,144 | 31,141 |
| Loss attributable to noncontrolling interests | 421 | | 421 | |
| Income (loss) attributable to Kindred | $ (5,532) | $ 16,277 | $ 16,565 | $ 31,141 |
| Amounts attributable to Kindred stockholders: | | | | |
| Income (loss) from continuing operations | $ (6,119) | $ 16,136 | $ 16,157 | $ 31,291 |
| Income (loss) from discontinued operations | 587 | 141 | 408 | (150) |
| Net income (loss) | $ (5,532) | $ 16,277 | $ 16,565 | $ 31,141 |
| Earnings (loss) per common share: | | | | |
| Basic: | | | | |
| Income (loss) from continuing operations | $ (0.14) | $ 0.41 | $ 0.39 | $ 0.79 |
| Discontinued operations: | | | | |
| Income (loss) from operations | 0.01 | | 0.01 | |
| Gain (loss) on divestiture of operations | | | | |
| Net income (loss) | $ (0.13) | $ 0.41 | $ 0.40 | $ 0.79 |

| | | | | |
|---|---|---|---|---|
| Diluted: | | | | |
| Income (loss) from continuing operations | $ (0.14) | $ 0.41 | $ 0.38 | $ 0.79 |
| Discontinued operations: | | | | |
| Income (loss) from operations | 0.01 | | 0.01 | |
| Gain (loss) on divestiture of operations | | | | |
| Net income (loss) | $ (0.13) | $ 0.41 | $ 0.39 | $ 0.79 |
| Shares used in computing earnings (loss) per common share: | | | | |
| Basic | 43,231 | 38,756 | 41,145 | 38,691 |
| Diluted | 43,231 | 38,914 | 41,661 | 38,881 |

See accompanying notes.

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**KINDRED HEALTHCARE, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEET**

**(Unaudited)**

**(In thousands, except per share amounts)**

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 52,399 | $ 17,168 |
| Cash restricted | 5,457 | 5,494 |
| Insurance subsidiary investments | 61,519 | 76,753 |
| Accounts receivable less allowance for loss of $15,791 June 30, 2011 and $13,584 December 31, 2010 | 944,742 | 631,877 |
| Inventories | 30,762 | 24,327 |
| Deferred tax assets | 29,705 | 13,439 |
| Income taxes | 15,770 | 42,118 |
| Other | 35,266 | 24,862 |
| | 1,175,620 | 836,038 |
| Property and equipment | 1,939,698 | 1,754,170 |
| Accumulated depreciation | (907,710) | (857,623) |
| | 1,031,988 | 896,547 |
| Goodwill | 1,097,997 | 242,420 |
| Intangible assets less accumulated amortization of $6,104 June 30, 2011 and $3,731 December 31, 2010 | 499,920 | 92,883 |
| Assets held for sale | 7,073 | 7,167 |
| Insurance subsidiary investments | 110,633 | 101,210 |
| Deferred tax assets | | 88,816 |
| Other | 133,365 | 72,334 |
| Total assets | $ 4,056,596 | $ 2,337,415 |
| **LIABILITIES AND EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 217,034 | $ 174,495 |
| Salaries, wages and other compensation | 401,014 | 291,116 |
| Due to third party payors | 40,293 | 27,115 |
| Professional liability risks | 40,583 | 41,555 |
| Other accrued liabilities | 119,270 | 87,012 |
| Long-term debt due within one year | 10,435 | 91 |
| | 828,629 | 621,384 |
| Long-term debt | 1,433,257 | 365,556 |
| Professional liability risks | 227,986 | 207,669 |
| Deferred tax liabilities | 36,670 | |
| Deferred credits and other liabilities | 127,304 | 111,047 |
| Noncontrolling interests-redeemable | 23,841 | |
| Commitments and contingencies | | |

| | | |
|---|---|---|
| Equity: | | |
| Stockholders equity: | | |
| Common stock, $0.25 par value; authorized 175,000 shares; issued 52,116 shares June 30, 2011 and 39,495 shares December 31, 2010 | 13,029 | 9,874 |
| Capital in excess of par value | 1,132,748 | 828,593 |
| Accumulated other comprehensive income | 317 | 135 |
| Retained earnings | 209,218 | 193,157 |
| | 1,355,312 | 1,031,759 |
| Noncontrolling interests-nonredeemable | 23,597 | |
| Total equity | 1,378,909 | 1,031,759 |
| Total liabilities and equity | $ 4,056,596 | $ 2,337,415 |

See accompanying notes.

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**KINDRED HEALTHCARE, INC.**

**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

**(Unaudited)**

**(In thousands)**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Cash flows from operating activities: | | | | |
| Net income (loss) | $ (5,953) | $ 16,277 | $ 16,144 | $ 31,141 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 37,871 | 29,852 | 70,420 | 60,973 |
| Amortization of stock-based compensation costs | 3,462 | 2,746 | 6,106 | 5,521 |
| Payment of lender fees related to debt issuance | (46,232) | | (46,232) | |
| Provision for doubtful accounts | 8,426 | 5,846 | 14,256 | 12,277 |
| Deferred income taxes | (1,959) | (3,264) | (2,689) | (10,727) |
| (Gain) loss on divestiture of discontinued operations | | (54) | | 83 |
| Other | 2,017 | 1,089 | 2,387 | 926 |
| Change in operating assets and liabilities: | | | | |
| Accounts receivable | (43,935) | 29,601 | (80,575) | (29,525) |
| Inventories and other assets | 870 | 4,759 | (2,655) | (6,486) |
| Accounts payable | 13,565 | (596) | 1,217 | (8,178) |
| Income taxes | (12,950) | (7,533) | 27,673 | 21,753 |
| Due to third party payors | 6,577 | (130) | 3,555 | (2,024) |
| Other accrued liabilities | 43,093 | 18,349 | 41,681 | 7,212 |
| Net cash provided by operating activities | 4,852 | 96,942 | 51,288 | 82,946 |
| Cash flows from investing activities: | | | | |
| Routine capital expenditures | (33,950) | (25,670) | (58,668) | (40,485) |
| Development capital expenditures | (14,309) | (12,288) | (25,418) | (19,855) |
| Acquisitions, net of cash acquired | (651,952) | (1,794) | (659,979) | (49,490) |
| Sale of assets | | | 1,714 | |
| Purchase of insurance subsidiary investments | (9,220) | (9,840) | (17,037) | (24,118) |
| Sale of insurance subsidiary investments | 8,533 | 8,622 | 27,189 | 61,833 |
| Net change in insurance subsidiary cash and cash equivalents | (2,744) | (1,926) | (4,044) | (7,501) |
| Change in other investments | | 2 | 1,000 | 2 |
| Other | (161) | 609 | (29) | 581 |
| Net cash used in investing activities | (703,803) | (42,285) | (735,272) | (79,033) |
| Cash flows from financing activities: | | | | |
| Proceeds from borrowings under revolving credit | 654,900 | 262,400 | 1,100,100 | 652,000 |
| Repayment of borrowings under revolving credit | (814,900) | (319,000) | (1,275,100) | (659,600) |
| Proceeds from issuance of senior unsecured notes | 550,000 | | 550,000 | |
| Proceeds from issuance of term loan, net of discount | 693,000 | | 693,000 | |
| Repayment of other long-term debt | (345,666) | (21) | (345,688) | (42) |
| Payment of deferred financing costs | (6,443) | (31) | (6,860) | (53) |
| Issuance of common stock | 1,604 | | 3,019 | 35 |
| Other | 355 | 222 | 744 | 346 |

| | | | | |
|---|---|---|---|---|
| Net cash provided by (used in) financing activities | 732,850 | (56,430) | 719,215 | (7,314) |
| Change in cash and cash equivalents | 33,899 | (1,773) | 35,231 | (3,401) |
| Cash and cash equivalents at beginning of period | 18,500 | 14,675 | 17,168 | 16,303 |
| Cash and cash equivalents at end of period | $ 52,399 | $ 12,902 | $ 52,399 | $ 12,902 |
| Supplemental information: | | | | |
| Issuance of common stock in RehabCare acquisition | $ 300,426 | $ | $ 300,426 | $ |
| Financing costs paid in connection with RehabCare acquisition | 13,074 | | 13,074 | |
| Interest payments | 4,056 | 1,391 | 6,944 | 2,266 |
| Income tax payments (refunds) | 11,503 | 21,965 | (13,283) | 10,553 |

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 long-term acute care ( LTAC ) hospitals, inpatient rehabilitation hospitals, nursing and rehabilitation centers, assisted living facilities and a contract rehabilitation services business across the United States (collectively, the Company or Kindred ). At June 30, 2011, the Company s hospital division operated 120 LTAC hospitals and five inpatient rehabilitation hospitals in 26 states. The Company s nursing center division operated 224 nursing and rehabilitation centers and six assisted living facilities in 27 states. The Company s rehabilitation division provides rehabilitative services primarily in hospital and long-term care settings in 46 states.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing and rehabilitation centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains or losses 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 June 30, 2011 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 4 for a summary of discontinued operations.

*Recently issued accounting requirements*

In July 2011, the Financial Accounting Standards Board (the FASB ) issued authoritative guidance related to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain healthcare entities. The provisions of the guidance require healthcare entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess a patient s ability to pay, to present the provision for bad debts related to those revenues as a deduction from patient service revenue (net of contractual allowances and discounts), as opposed to an operating expense. All other entities would continue to present the provision for bad debts as an operating expense. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011, with early adoption permitted. These amendments should be applied retrospectively to all prior periods presented. The disclosures required should be provided for the period of adoption and subsequent reporting periods. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. Early adoption is permitted, but full retrospective application is required. The adoption of the guidance will not have a material impact on the Company s business, financial position, results of operations or liquidity.

In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in common fair value measurement and disclosure requirements in United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily change the wording used to describe many of the requirements in generally accepted accounting principles for measuring and disclosing information about fair value measurements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

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

*Recently issued accounting requirements (Continued)*

In December 2010, the FASB issued authoritative guidance related to goodwill and other intangibles. The provisions of the guidance modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining if it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2010, the FASB issued authoritative guidance related to business combinations. The provisions of the guidance specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during a particular year had occurred as of the beginning of the comparable prior year annual reporting period. Supplemental pro forma disclosures also have been expanded to include a description of the nature and amount of material, non-recurring pro forma adjustments included in the pro forma financial statements. The guidance is effective prospectively for business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In January 2010, the FASB issued authoritative guidance related to fair value measurements and disclosures. The provisions of the guidance require new disclosures related to transfers in and out of Levels 1 and 2 classifications (as described in Note 12). The provisions also require a reconciliation of the activity in Level 3 (as described in Note 12) recurring fair value measurements. Existing disclosures also were expanded to include Level 2 fair value measurement valuation techniques and inputs. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2009, except for the disclosures for Level 3 activity which is effective for fiscal years beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, 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):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net income (loss) | $ (5,953) | $ 16,277 | $ 16,144 | $ 31,141 |
| Net unrealized investment gains (losses), net of income taxes | (76) | (400) | 182 | (201) |
| Comprehensive income (loss) | (6,029) | 15,877 | 16,326 | 30,940 |
| Loss attributable to noncontrolling interests redeemable | 28 | | 28 | |
| Loss attributable to noncontrolling interests nonredeemable | 393 | | 393 | |

| | | | | |
|---|---|---|---|---|
| Comprehensive income (loss) attributable to Kindred | $ (5,608) | $ 15,877 | $ 16,747 | $ 30,940 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

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

*Equity*

The following table sets forth a reconciliation of the carrying amount of equity attributable to Kindred, equity attributable to nonredeemable noncontrolling interests and total equity (in thousands):

| | Amounts attributable to Kindred stockholders | Nonredeemable noncontrolling interests | Total equity |
|---|---|---|---|
| Balance at December 31, 2010 | $ 1,031,759 | $ | $ 1,031,759 |
| Acquired noncontrolling interests nonredeemable | | 23,990 | 23,990 |
| Comprehensive income: | | | |
| Net income (loss) | 16,565 | (393) | 16,172 |
| Net unrealized investment gains, net of income taxes | 182 | | 182 |
| Comprehensive income (loss) | 16,747 | (393) | 16,354 |
| Issuance of common stock in connection with employee benefit plans | 3,019 | | 3,019 |
| Shares tendered by employees for statutory tax withholdings upon issuance of common stock | (3,353) | | (3,353) |
| Income tax benefit in connection with the issuance of common stock under employee benefit plans | 608 | | 608 |
| Stock-based compensation amortization | 6,106 | | 6,106 |
| Equity consideration for acquisition (See Note 2) | 300,426 | | 300,426 |
| Balance at June 30, 2011 | $ 1,355,312 | $ 23,597 | $ 1,378,909 |

*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, 2010 filed with the Securities and Exchange Commission (the SEC ) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2010 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.

*Reclassifications*

Certain prior period amounts have been reclassified to conform with the current period presentation.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 2 REHABCARE ACQUISITION**

On June 1, 2011, the Company completed the acquisition of RehabCare Group, Inc. ( RehabCare ) (the Merger ). Upon consummation of the Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive 0.471 of a share of Kindred common stock and $26 per share in cash, without interest (the Merger Consideration ). Kindred issued approximately 12 million shares of its common stock in connection with the Merger. The purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of Kindred common stock at fair value. The Company also assumed $356 million of long-term debt in the Merger, of which $345 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in the accompanying unaudited condensed consolidated financial statements of the Company since June 1, 2011.

At the Merger date, the Company acquired 32 LTAC hospitals, five inpatient rehabilitation hospitals, approximately 1,200 rehabilitation therapy sites of service and 102 hospital-based inpatient rehabilitation units. The Merger will expand the Company s service offerings, position the Company for future growth and provide for significant operating synergies. RehabCare reported consolidated revenues of approximately $1.3 billion and net income from continuing operations of approximately $65 million in fiscal 2010.

Operating results for the second quarter of 2011 include transaction costs totaling $19.1 million, financing costs totaling $11.8 million and severance costs totaling $14.9 million related to the Merger. Operating results for the six months ended June 30, 2011 include transaction costs totaling $23.0 million, financing costs totaling $13.8 million and severance costs totaling $14.9 million related to the Merger. In the accompanying unaudited condensed consolidated statement of operations, transaction costs were included in other operating expenses, financing costs were included in interest expense and severance costs were included in salaries, wages and benefits.

*New credit facilities and notes*

In connection with the Merger, the Company entered into a new $650 million senior secured asset-based revolving credit facility (the ABL Facility ), a new $700 million senior secured term loan facility (the Term Loan Facility ) and successfully completed the private placement of $550 million of senior notes due 2019 (the Notes ). The Company used proceeds from the ABL Facility, the Term Loan Facility and the Notes to pay the Merger Consideration, repay all amounts outstanding under Kindred s and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under Kindred s and RehabCare s former credit facilities that were repaid at the Merger closing were $390 million and $345 million, respectively. The ABL Facility and the Term Loan Facility have incremental facility capacity in an aggregate amount between the two facilities of $200 million, subject to meeting certain conditions, including a specified senior secured leverage ratio. In connection with these new credit arrangements, the Company paid $46 million of lender fees related to debt issuance that were capitalized as deferred financing costs and paid $13 million of other financing costs that were included in interest expense.

All obligations under the ABL Facility and the Term Loan Facility are fully and unconditionally guaranteed, subject to certain exceptions, by substantially all of the Company s existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as the Company may determine from time to time in its sole discretion. The Notes are guaranteed by substantially all of the Company s domestic 100% owned subsidiaries.

The agreements governing the ABL Facility, the Term Loan Facility and the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 2 REHABCARE ACQUISITION (Continued)**

*New credit facilities and notes (Continued)*

and financial restrictions on the Company and certain of its subsidiaries. In addition, the Company is required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio. These financing agreements also contain customary affirmative covenants and events of default.

*ABL Facility*

The ABL Facility has a five-year tenor and is secured by a first priority lien on eligible accounts receivable, cash, deposit accounts, and certain other assets and property and proceeds from the foregoing (the First Priority ABL Collateral ). The ABL Facility has a second priority lien on substantially all of the other assets and properties of the Company. As of June 30, 2011, the Company had $190 million outstanding under the ABL Facility. In addition, approximately $13 million of letters of credit were issued under the ABL Facility to backstop outstanding letters of credit previously issued by RehabCare under its terminated credit facility.

Borrowings under the ABL Facility bear interest at a rate per annum equal to the applicable margin plus, at the Company s option, either (1) the London Interbank Offered Rate ( LIBOR ) determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. The initial applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. Commencing with the completion of the Company s first fiscal quarter ending after the Merger, the applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

*Term Loan Facility*

The Term Loan Facility has a tenor of seven years and is secured by a first priority lien on substantially all of the Company s assets and properties other than the First Priority ABL Collateral and a second priority lien on the First Priority ABL Collateral. The Term Loan Facility net proceeds totaled $693 million, net of a $7 million original issue discount that will be amortized over the tenor of the Term Loan Facility.

Borrowings under the Term Loan Facility bear interest at a rate per annum equal to an applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The initial applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings.

*Notes*

In connection with the Merger, the Company completed a private placement of the Notes.

The Notes bear interest at an annual rate equal to 8.25% and are senior unsecured obligations of the Company and the subsidiary guarantors, ranking *pari passu* with all of their respective existing and future senior unsubordinated indebtedness. The indenture contains certain restrictive

covenants that will, among other things,

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 2 REHABCARE ACQUISITION (Continued)**

*Notes (Continued)*

limit the Company and certain of its subsidiaries ability to incur, assume or guarantee additional indebtedness; pay dividends, make distributions or redeem or repurchase stock; restrict dividends, loans or asset transfers from its subsidiaries; sell or otherwise dispose of assets; and enter into transactions with affiliates. These covenants are subject to a number of limitations and exceptions. The indenture also contains customary events of default.

Pursuant to a registration rights agreement, the Company has agreed to use its commercially reasonable efforts to file with the SEC a registration statement relating to an offer to exchange the Notes for an issue of SEC-registered notes with substantially identical terms.

*Purchase price allocation*

The Merger purchase price of $963 million was allocated on a preliminary basis to the estimated fair value of the tangible and intangible assets, and goodwill.

The following is the preliminary Merger purchase price allocation (in thousands):

| | |
|---|---|
| Cash and cash equivalents | $ 19,932 |
| Accounts receivable | 246,546 |
| Deferred income taxes and other current assets | 46,511 |
| Property and equipment | 114,079 |
| Identifiable intangible assets: | |
| Customer relationships | 188,900 |
| Trade names (indefinite life) | 115,400 |
| Medicare certifications (indefinite life) | 75,900 |
| Trade name | 16,600 |
| Certificates of need (indefinite life) | 7,900 |
| Non-compete agreements | 2,800 |
| Total identifiable intangible assets | 407,500 |
| Other assets | 11,023 |
| Accounts payable and other current liabilities | (168,080) |
| Long-term debt, including amounts due within one year | (355,650) |
| Deferred income taxes and other liabilities | (159,304) |
| Noncontrolling interests redeemable | (23,869) |
| Noncontrolling interests nonredeemable | (23,990) |
| Total identifiable net assets | 114,698 |
| Goodwill | 848,110 |

| | |
|---|---|
| Net assets | $ 962,808 |

The fair value allocation was measured primarily using a discounted cash flows methodology, which is considered a Level 3 (as described in Note 12) input.

The value of gross contractual accounts receivable before determining uncollectable amounts totaled $263 million. Accounts estimated to be uncollectable totaled $16 million.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 2 REHABCARE ACQUISITION (Continued)**

*Purchase price allocation (Continued)*

The weighted average life of the definite lived intangible assets is 13 years, which primarily consists of customer relationships.

The total goodwill arising from the Merger is based upon the expected future cash flows of the RehabCare operations which reflects both growth expectations and cost savings from combining the operations of the Company and RehabCare. Goodwill is not amortized and is not deductible for income tax purposes. Goodwill was preliminarily assigned to the Company s hospital reporting unit ($587 million), skilled nursing rehabilitation services reporting unit ($122 million) and hospital rehabilitation services reporting unit ($139 million).

The valuation technique used to measure the value of the noncontrolling interests was an average of the implied equity value of the noncontrolling interests based upon the Merger Consideration and market multiple methodologies. Redeemable noncontrolling interests as of June 30, 2011 represent the minority ownership interests containing put rights in connection with the Merger.

The unaudited pro forma net effect of the Merger assuming the acquisition occurred as of January 1, 2010 is as follows (in thousands, except per share amounts):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Revenues | $ 1,533,515 | $ 1,412,028 | $ 3,090,535 | $ 2,823,819 |
| Income (loss) from continuing operations attributable to Kindred | 25,501 | 15,949 | 62,027 | (6,595) |
| Income (loss) attributable to Kindred | 26,163 | 15,549 | 65,478 | (6,722) |
| Earnings (loss) per common share: | | | | |
| Basic: | | | | |
| Income (loss) from continuing operations | $ 0.49 | $ 0.31 | $ 1.19 | $ (0.13) |
| Net income (loss) | $ 0.50 | $ 0.30 | $ 1.26 | $ (0.13) |
| Diluted: | | | | |
| Income (loss) from continuing operations | $ 0.49 | $ 0.31 | $ 1.18 | $ (0.13) |
| Net income (loss) | $ 0.50 | $ 0.30 | $ 1.25 | $ (0.13) |

The unaudited pro forma financial data has been derived by combining the historical financial results of the Company and the operations acquired in the Merger for the periods presented. The unaudited pro forma financial data includes transaction, financing and severance costs totaling $74.5 million incurred by both the Company and RehabCare related to the Merger. These costs have been eliminated from results of operations for 2011 and have been reflected as expenses incurred as of January 1, 2010 for pro forma purposes. Revenues and operating income associated with RehabCare aggregated $114 million and $17 million, respectively, for the one month ended June 30, 2011.

**NOTE 3 OTHER ACQUISITIONS**

The following is a summary of the Company s other significant acquisition activities. The operating results of the acquired businesses have been included in the accompanying unaudited condensed consolidated financial statements of the Company from the respective acquisition dates. The purchase price of the acquired businesses and acquired leased facilities resulted from negotiations with each of the sellers that were based upon

both the historical and expected future cash flows of the respective businesses and real estate values. All of these acquisitions were financed through borrowings under the Company s former revolving credit facility. Unaudited pro formas related to acquired new businesses have not been presented because the acquisitions are not material, either individually or in the aggregate, to the Company s consolidated financial statements.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 3 OTHER ACQUISITIONS (Continued)**

In April 2011, the Company acquired a home health company for $9.5 million, which included $0.1 million of property and equipment, $7.5 million of goodwill and $1.9 million of identifiable intangible assets.

In March 2011, the Company acquired the real estate of a previously leased hospital for $8.0 million. Annual rent associated with the hospital aggregated $0.9 million.

In March 2010, the Company acquired a combined nursing and rehabilitation center and assisted living facility for $16.6 million, which included $0.2 million of goodwill, $2.2 million of identifiable intangible assets and $14.2 million of property and equipment and other assets.

In January 2010, the Company acquired the real estate of two previously leased hospitals and two previously leased nursing and rehabilitation centers for $31.1 million in cash and $2.4 million in unamortized prepaid rent. Annual rents associated with these four facilities aggregated $2.9 million.

The fair value of each of the acquisitions noted above was measured primarily using discounted cash flow methodologies which are considered Level 3 (as described in Note 12) inputs.

**NOTE 4 DISCONTINUED OPERATIONS**

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestitures 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 or losses related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At June 30, 2011, the Company held for sale two hospitals reported as discontinued operations.

A summary of discontinued operations follows (in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Revenues | $ 208 | $ 3,646 | $ 177 | $ 7,448 |
| Salaries, wages and benefits | (160) | 2,506 | (316) | 5,011 |
| Supplies | (1) | 185 | (3) | 395 |
| Rent | 29 | 36 | 58 | 72 |
| Other operating expenses (income) | (615) | 778 | (225) | 2,105 |
| Depreciation | | | | |
| Interest expense | | | | |
| Investment income | | | | (26) |
| | (747) | 3,505 | (486) | 7,557 |

| | | | | |
|---|---|---|---|---|
| Income (loss) from operations before income taxes | 955 | 141 | 663 | (109) |
| Provision (benefit) for income taxes | 368 | 54 | 255 | (42) |
| Income (loss) from operations | 587 | 87 | 408 | (67) |
| Gain (loss) on divestiture of operations, net of income taxes | | 54 | | (83) |
| | $ 587 | $ 141 | $ 408 | $ (150) |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 4 DISCONTINUED OPERATIONS (Continued)**

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| **Revenues:** | | | | |
| Hospital division | $ 11 | $ 99 | $ (24) | $ 107 |
| Nursing center division | 197 | 3,547 | 201 | 7,341 |
| | $ 208 | $ 3,646 | $ 177 | $ 7,448 |
| **Operating income (loss):** | | | | |
| Hospital division | $ (282) | $ (20) | $ (698) | $ (837) |
| Nursing center division | 1,266 | 197 | 1,419 | 774 |
| | $ 984 | $ 177 | $ 721 | $ (63) |
| **Rent:** | | | | |
| Hospital division | $ 29 | $ 33 | $ 58 | $ 64 |
| Nursing center division | | 3 | | 8 |
| | $ 29 | $ 36 | $ 58 | $ 72 |

A summary of the net assets held for sale, including certain assets included in continuing operations, follows (in thousands):

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| Long-term assets: | | |
| Property and equipment, net | $ 7,073 | $ 7,062 |
| Other | | 105 |
| | 7,073 | 7,167 |
| Current liabilities (included in other accrued liabilities) | (113) | (72) |
| | $ 6,960 | $ 7,095 |

**NOTE 5 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 June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Medicare | $ 576,778 | $ 468,020 | $ 1,132,568 | $ 943,437 |
| Medicaid | 262,450 | 263,642 | 522,129 | 529,824 |
| Medicare Advantage | 98,074 | 87,919 | 193,455 | 173,823 |
| Other | 434,687 | 338,096 | 795,429 | 677,120 |
| | 1,371,989 | 1,157,677 | 2,643,581 | 2,324,204 |
| Eliminations | (79,397) | (76,313) | (158,568) | (153,003) |
| | $ 1,292,592 | $ 1,081,364 | $ 2,485,013 | $ 2,171,201 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

## NOTE 6 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. The Company follows 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.

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

| | Three months ended June 30, | | | | Six months ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | | 2010 | | 2011 | | 2010 | |
| | Basic | Diluted | Basic | Diluted | Basic | Diluted | Basic | Diluted |
| Earnings (loss): | | | | | | | | |
| Amounts attributable to Kindred stockholders: | | | | | | | | |
| Income (loss) from continuing operations: | | | | | | | | |
| As reported in Statement of Operations | $ (6,119) | $ (6,119) | $ 16,136 | $ 16,136 | $ 16,157 | $ 16,157 | $ 31,291 | $ 31,291 |
| Allocation to participating unvested restricted stockholders | | | (300) | (299) | (296) | (292) | (578) | (575) |
| Available to common stockholders | $ (6,119) | $ (6,119) | $ 15,836 | $ 15,837 | $ 15,861 | $ 15,865 | $ 30,713 | $ 30,716 |
| Discontinued operations, net of income taxes: | | | | | | | | |
| Income (loss) from operations: | | | | | | | | |
| As reported in Statement of Operations | $ 587 | $ 587 | $ 87 | $ 87 | $ 408 | $ 408 | $ (67) | $ (67) |
| Allocation to participating unvested restricted stockholders | | | (2) | (2) | (7) | (7) | 1 | 1 |
| Available to common stockholders | $ 587 | $ 587 | $ 85 | $ 85 | $ 401 | $ 401 | $ (66) | $ (66) |
| Gain (loss) on divestiture of operations: | | | | | | | | |
| As reported in Statement of Operations | $ | $ | $ 54 | $ 54 | $ | $ | $ (83) | $ (83) |
| Allocation to participating unvested restricted stockholders | | | (1) | (1) | | | 2 | 2 |
| Available to common stockholders | $ | $ | $ 53 | $ 53 | $ | $ | $ (81) | $ (81) |
| Net income (loss): | | | | | | | | |
| As reported in Statement of Operations | $ (5,532) | $ (5,532) | $ 16,277 | $ 16,277 | $ 16,565 | $ 16,565 | $ 31,141 | $ 31,141 |
| Allocation to participating unvested restricted stockholders | | | (303) | (302) | (303) | (299) | (575) | (572) |
| Available to common stockholders | $ (5,532) | $ (5,532) | $ 15,974 | $ 15,975 | $ 16,262 | $ 16,266 | $ 30,566 | $ 30,569 |

Shares used in the computation:

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Weighted average shares outstanding basic computation | 43,231 | 43,231 | 38,756 | 38,756 | 41,145 | 41,145 | 38,691 | 38,691 |
| Dilutive effect of employee stock options | | | | 158 | | 516 | | 190 |
| Adjusted weighted average shares outstanding diluted computation | | 43,231 | | 38,914 | | 41,661 | | 38,881 |
| Earnings (loss) per common share: | | | | | | | | |
| Income (loss) from continuing operations | $ (0.14) | $ (0.14) | $ 0.41 | $ 0.41 | $ 0.39 | $ 0.38 | $ 0.79 | $ 0.79 |
| Discontinued operations: | | | | | | | | |
| Income (loss) from operations | 0.01 | 0.01 | | | 0.01 | 0.01 | | |
| Gain (loss) on divestiture of operations | | | | | | | | |
| Net income (loss) | $ (0.13) | $ (0.13) | $ 0.41 | $ 0.41 | $ 0.40 | $ 0.39 | $ 0.79 | $ 0.79 |
| Number of antidilutive stock options excluded from shares used in the diluted earnings (loss) per common share computation | | 836 | | 2,499 | | 1,094 | | 2,079 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 7 BUSINESS SEGMENT DATA**

At June 30, 2011, the Company operated three divisions consisting of hospitals, nursing centers and rehabilitation services. Based upon the authoritative guidance for business segments and after giving consideration to the Company s business segments after the Merger, the divisions represent four reportable operating segments, which consist of (i) LTAC hospitals, (ii) skilled nursing and rehabilitation centers, (iii) skilled nursing-based rehabilitation contract therapy services, and (iv) hospital-based rehabilitation contract therapy services. The Company includes operating data for its home health and hospice businesses in the skilled nursing-based rehabilitation contract therapy services segment. These segments are consistent with information used by our Chief Executive Officer and Chief Operating Officer to assess performance and allocate resources. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Prior period segment information has been conformed to the current period presentation.

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.

Operating income for the six months ended June 30, 2010 included severance and retirement costs approximating $1.1 million for the hospital division, $0.5 million for the nursing center division and $1.3 million for corporate.

Transaction costs for the three and six months ended June 30, 2010 have been reclassified to conform with the current period presentation and are excluded from business segment operating income (loss).

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 7 BUSINESS SEGMENT DATA (Continued)**

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| **Revenues:** | | | | |
| Hospital division | $ 593,425 | $ 493,401 | $ 1,152,399 | $ 1,000,463 |
| Nursing center division | 568,199 | 542,215 | 1,135,671 | 1,081,536 |
| Rehabilitation division: | | | | |
| Skilled nursing rehabilitation services | 172,074 | 101,148 | 294,730 | 200,145 |
| Hospital rehabilitation services | 38,291 | 20,913 | 60,781 | 42,060 |
| | 210,365 | 122,061 | 355,511 | 242,205 |
| | 1,371,989 | 1,157,677 | 2,643,581 | 2,324,204 |
| Eliminations | (79,397) | (76,313) | (158,568) | (153,003) |
| | $ 1,292,592 | $ 1,081,364 | $ 2,485,013 | $ 2,171,201 |
| **Income (loss) from continuing operations:** | | | | |
| Operating income (loss): | | | | |
| Hospital division | $ 108,465 | $ 91,790 | $ 216,850 | $ 187,230 |
| Nursing center division | 93,532 | 76,529 | 180,882 | 147,143 |
| Rehabilitation division: | | | | |
| Skilled nursing rehabilitation services | 15,531 | 9,307 | 24,680 | 18,844 |
| Hospital rehabilitation services | 8,033 | 4,793 | 13,365 | 9,939 |
| | 23,564 | 14,100 | 38,045 | 28,783 |
| Corporate: | | | | |
| Overhead | (43,801) | (32,799) | (82,116) | (66,630) |
| Insurance subsidiary | (420) | (791) | (1,022) | (1,271) |
| | (44,221) | (33,590) | (83,138) | (67,901) |
| Transaction costs | (34,851) | (955) | (39,030) | (1,725) |
| Operating income | 146,489 | 147,874 | 313,609 | 293,530 |
| Rent | (95,677) | (88,981) | (187,130) | (177,300) |
| Depreciation and amortization | (37,871) | (29,852) | (70,420) | (60,973) |
| Interest, net | (22,900) | (1,675) | (28,133) | (2,105) |

| | | | | |
|---|---|---|---|---|
| Income (loss) from continuing operations before income taxes | (9,959) | 27,366 | 27,926 | 53,152 |
| Provision (benefit) for income taxes | (3,419) | 11,230 | 12,190 | 21,861 |
| | $ (6,540) | $ 16,136 | $ 15,736 | $ 31,291 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 7 BUSINESS SEGMENT DATA (Continued)**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| **Rent:** | | | | |
| Hospital division | $ 43,997 | $ 38,043 | $ 84,296 | $ 75,458 |
| Nursing center division | 49,562 | 49,439 | 98,946 | 98,831 |
| Rehabilitation division: | | | | |
| Skilled nursing rehabilitation services | 1,791 | 1,445 | 3,489 | 2,894 |
| Hospital rehabilitation services | 33 | 25 | 61 | 51 |
| | 1,824 | 1,470 | 3,550 | 2,945 |
| Corporate | 294 | 29 | 338 | 66 |
| | $ 95,677 | $ 88,981 | $ 187,130 | $ 177,300 |
| **Depreciation and amortization:** | | | | |
| Hospital division | $ 16,572 | $ 12,549 | $ 30,850 | $ 25,563 |
| Nursing center division | 13,038 | 11,185 | 24,831 | 23,298 |
| Rehabilitation division: | | | | |
| Skilled nursing rehabilitation services | 1,339 | 558 | 2,098 | 1,081 |
| Hospital rehabilitation services | 819 | 68 | 916 | 130 |
| | 2,158 | 626 | 3,014 | 1,211 |
| Corporate | 6,103 | 5,492 | 11,725 | 10,901 |
| | $ 37,871 | $ 29,852 | $ 70,420 | $ 60,973 |
| **Capital expenditures, excluding acquisitions (including discontinued operations):** | | | | |
| Hospital division: | | | | |
| Routine | $ 11,809 | $ 7,954 | $ 23,953 | $ 14,019 |
| Development | 6,423 | 10,209 | 14,200 | 15,983 |
| | 18,232 | 18,163 | 38,153 | 30,002 |
| Nursing center division: | | | | |
| Routine | 8,000 | 9,135 | 16,155 | 13,184 |
| Development | 7,705 | 2,079 | 11,027 | 3,872 |
| | 15,705 | 11,214 | 27,182 | 17,056 |
| Rehabilitation division: | | | | |
| Skilled nursing rehabilitation services: | | | | |
| Routine | 217 | 258 | 472 | 486 |
| Development | 181 | | 191 | |

| | | | | |
|---|---|---|---|---|
| | 398 | 258 | 663 | 486 |
| Hospital rehabilitation services: | | | | |
| Routine | 72 | 23 | 97 | 62 |
| Development | | | | |
| | 72 | 23 | 97 | 62 |
| Corporate: | | | | |
| Information systems | 13,641 | 7,853 | 17,573 | 11,999 |
| Other | 211 | 447 | 418 | 735 |
| | $ 48,259 | $ 37,958 | $ 84,086 | $ 60,340 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 7 BUSINESS SEGMENT DATA (Continued)**

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| **Assets at end of period:** | | |
| Hospital division | $ 2,104,268 | $ 1,100,138 |
| Nursing center division | 658,252 | 647,355 |
| Rehabilitation division: | | |
| Skilled nursing rehabilitation services | 484,315 | 87,055 |
| Hospital rehabilitation services | 323,179 | 798 |
| | 807,494 | 87,853 |
| Corporate | 486,582 | 502,069 |
| | $ 4,056,596 | $ 2,337,415 |
| **Goodwill:** | | |
| Hospital division | $ 800,431 | $ 213,200 |
| Nursing center division | 6,080 | 6,080 |
| Rehabilitation division: | | |
| Skilled nursing rehabilitation services | 152,566 | 23,140 |
| Hospital rehabilitation services | 138,920 | |
| | 291,486 | 23,140 |
| | $ 1,097,997 | $ 242,420 |

**NOTE 8 INSURANCE RISKS**

The Company insures a substantial portion of its professional liability risks and workers compensation risks through its 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 June 30, | Six months ended June 30, |
|---|---|---|

| | 2011 | 2010 | 2011 | 2010 |
|---|---|---|---|---|
| Professional liability: | | | | |
| Continuing operations | $ 16,871 | $ 15,568 | $ 34,631 | $ 32,838 |
| Discontinued operations | (942) | (394) | (821) | (829) |
| Workers compensation: | | | | |
| Continuing operations | $ 14,081 | $ 10,716 | $ 27,149 | $ 21,714 |
| Discontinued operations | (219) | (242) | (520) | (1,001) |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 8 INSURANCE RISKS (Continued)**

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

| | June 30, 2011 | | | December 31, 2010 | | |
|---|---|---|---|---|---|---|
| | Professional liability | Workers compensation | Total | Professional liability | Workers compensation | Total |
| **Assets:** | | | | | | |
| Current: | | | | | | |
| Insurance subsidiary investments | $ 38,876 | $ 22,643 | $ 61,519 | $ 54,162 | $ 22,591 | $ 76,753 |
| Reinsurance recoverables | 258 | | 258 | 265 | | 265 |
| Other | | 320 | 320 | | 319 | 319 |
| | 39,134 | 22,963 | 62,097 | 54,427 | 22,910 | 77,337 |
| Non-current: | | | | | | |
| Insurance subsidiary investments | 46,602 | 64,031 | 110,633 | 38,635 | 62,575 | 101,210 |
| Reinsurance and other recoverables | 42,987 | | 42,987 | 41,752 | 3,222 | 44,974 |
| Deposits | 3,643 | 1,623 | 5,266 | 3,000 | 1,313 | 4,313 |
| Other | | 43 | 43 | | 44 | 44 |
| | 93,232 | 65,697 | 158,929 | 83,387 | 67,154 | 150,541 |
| | $ 132,366 | $ 88,660 | $ 221,026 | $ 137,814 | $ 90,064 | $ 227,878 |
| **Liabilities:** | | | | | | |
| Allowance for insurance risks: | | | | | | |
| Current | $ 40,583 | $ 28,524 | $ 69,107 | $ 41,555 | $ 24,676 | $ 66,231 |
| Non-current | 227,986 | 69,816 | 297,802 | 207,669 | 59,504 | 267,173 |
| | $ 268,569 | $ 98,340 | $ 366,909 | $ 249,224 | $ 84,180 | $ 333,404 |

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 1% to 5% depending upon the policy year. The discount rate was 1% for the 2011 and 2010 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 $271.7 million at June 30, 2011 and $252.6 million at December 31, 2010.

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.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

## NOTE 9 INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, debt securities, equities and commercial paper 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 follows (in thousands):

| | June 30, 2011 | | | | December 31, 2010 | | | |
|---|---|---|---|---|---|---|---|---|
| | Amortized cost | Unrealized gains | Unrealized losses | Fair value | Amortized cost | Unrealized gains | Unrealized losses | Fair value |
| Cash and cash equivalents (a) | $ 108,708 | $ | $ | $ 108,708 | $ 104,664 | $ | $ | $ 104,664 |
| Debt securities: | | | | | | | | |
| Corporate bonds | 24,191 | 284 | (12) | 24,463 | 32,174 | 542 | (40) | 32,676 |
| Debt securities issued by U.S. government agencies | 18,134 | 109 | (3) | 18,240 | 17,906 | 113 | (27) | 17,992 |
| U.S. Treasury notes | 1,851 | 12 | | 1,863 | 2,482 | 11 | | 2,493 |
| Debt securities issued by foreign governments | 1,010 | 13 | | 1,023 | 2,081 | 15 | | 2,096 |
| Commercial mortgage-backed securities | 230 | 13 | | 243 | 307 | 19 | | 326 |
| | 45,416 | 431 | (15) | 45,832 | 54,950 | 700 | (67) | 55,583 |
| Equities by industry: | | | | | | | | |
| Healthcare | 1,572 | 40 | (142) | 1,470 | 1,572 | 20 | (235) | 1,357 |
| Financial services | 1,284 | 140 | (127) | 1,297 | 1,284 | 209 | (66) | 1,427 |
| Oil and gas | 921 | 232 | (1) | 1,152 | 921 | 142 | (37) | 1,026 |
| Other | 7,594 | 1,269 | (277) | 8,586 | 7,594 | 876 | (269) | 8,201 |
| | 11,371 | 1,681 | (547) | 12,505 | 11,371 | 1,247 | (607) | 12,011 |
| Commercial paper | 5,105 | 2 | | 5,107 | 5,705 | 2 | (2) | 5,705 |
| | $ 170,600 | $ 2,114 | $ (562) | $ 172,152 | $ 176,690 | $ 1,949 | $ (676) | $ 177,963 |

(a) Includes $1.1 million and $2.6 million of money market funds at June 30, 2011 and December 31, 2010, 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 severity and duration of its unrealized losses at June 30, 2011 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these investments. The Company recognized a $0.7 million pretax other-than-temporary impairment in the second quarter of 2010 for various

investments held in its insurance subsidiary investment portfolio.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 9 INSURANCE SUBSIDIARY INVESTMENTS (Continued)**

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $3 million and $22 million during the six months ended June 30, 2011 and 2010, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s former revolving credit facility.

**NOTE 10 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 losses 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 8.

*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 governmental audits and investigations in the ordinary course of business. The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental audits and investigations. These matters 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.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 11 CAPITAL STOCK**

In May 2011, the shareholders of the Company approved an additional three million shares of common stock that could be issued under the Company s incentive compensation plans.

**NOTE 12 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS**

The Company follows 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 related to fair value measures 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.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 12 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)**

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

| | Fair value measurements | | | Assets/liabilities at fair value | Total losses |
|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | | |
| **June 30, 2011:** | | | | | |
| Recurring: | | | | | |
| Assets: | | | | | |
| Available-for-sale debt securities: | | | | | |
| Corporate bonds | $ | $ 24,463 | $ | $ 24,463 | $ |
| Debt securities issued by U.S. government agencies | | 18,240 | | 18,240 | |
| U.S. Treasury notes | 1,863 | | | 1,863 | |
| Debt securities issued by foreign governments | | 1,023 | | 1,023 | |
| Commercial mortgage-backed securities | | 243 | | 243 | |
| | 1,863 | 43,969 | | 45,832 | |
| Available-for-sale equity securities | 12,505 | | | 12,505 | |
| Commercial paper | | 5,107 | | 5,107 | |
| Money market funds | 5,207 | | | 5,207 | |
| Total available-for-sale investments | 19,575 | 49,076 | | 68,651 | |
| Deposits held in money market funds | 17,557 | 3,644 | | 21,201 | |
| | $ 37,132 | $ 52,720 | $ | $ 89,852 | $ |
| Liabilities | $ | $ | $ | $ | $ |
| Non-recurring: | | | | | |
| Assets | $ | $ | $ | $ | $ |
| Liabilities | $ | $ | $ | $ | $ |
| **December 31, 2010:** | | | | | |
| Recurring: | | | | | |
| Assets: | | | | | |
| Available-for-sale debt securities: | | | | | |
| Corporate bonds | $ | $ 32,676 | $ | $ 32,676 | $ |
| Debt securities issued by U.S. government agencies | | 17,992 | | 17,992 | |
| U.S. Treasury notes | 2,493 | | | 2,493 | |
| Debt securities issued by foreign governments | | 2,096 | | 2,096 | |
| Commercial mortgage-backed securities | | 326 | | 326 | |

| | | | | | |
|---|---|---|---|---|---|
| | 2,493 | 53,090 | | 55,583 | |
| Available-for-sale equity securities | 12,011 | | | 12,011 | |
| Commercial paper | | 5,705 | | 5,705 | |
| Money market funds | 2,581 | | | 2,581 | |
| Total available-for-sale investments | 17,085 | 58,795 | | 75,880 | |
| Deposits held in money market funds | 7,238 | 3,001 | | 10,239 | |
| | $ 24,323 | $ 61,796 | $ | $ 86,119 | $ |
| Liabilities | $ | $ | $ | $ | $ |
| Non-recurring: | | | | | |
| Assets: | | | | | |
| Hospitals available for sale | $ | $ | $ 5,605 | $ 5,605 | $ (1,880) |
| Liabilities | $ | $ | $ | $ | $ |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 12 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)**

*Recurring measurements*

The Company s available-for-sale investments are primarily held by its limited purpose insurance subsidiary and consist of debt securities, equities, commercial paper and money market funds. These available-for-sale investments and the insurance subsidiary s cash and cash equivalents of $107.6 million as of June 30, 2011 and $102.1 million as of December 31, 2010, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company also has available-for-sale investments totaling $4.1 million related to a deferred compensation plan that is maintained for certain of the Company s current and former employees.

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 inactively traded debt securities and commercial paper 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. The Company s investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors in determining reasonable estimates of fair value. Based upon the Company s internal review procedures, there were no adjustments to the prices during the three or six months ended June 30, 2011 or June 30, 2010.

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.

| | June 30, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| (In thousands) | Carrying value | Fair value | Carrying value | Fair value |
| Cash and cash equivalents | $ 52,399 | $ 52,399 | $ 17,168 | $ 17,168 |
| Cash restricted | 5,457 | 5,457 | 5,494 | 5,494 |
| Insurance subsidiary investments | 172,152 | 172,152 | 177,963 | 177,963 |
| Other marketable securities | 4,133 | 4,133 | | |
| Tax refund escrow investments | 213 | 213 | 213 | 213 |
| Long-term debt, including amounts due within one year (excluding capital lease obligations totaling $5.5 million at June 30, 2011) | 1,438,220 | 1,442,489 | 365,647 | 365,640 |

**NOTE 13 SUBSEQUENT EVENT**

On July 29, 2011, CMS issued final rules which, among other things, will reduce Medicare payments to nursing centers by 11.1% and change the reimbursement for the provision of group rehabilitation therapy services to Medicare beneficiaries.

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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 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, 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:

- the impact of a final rule issued by CMS on July 29, 2011 providing for a 11.1% reduction in Medicare reimbursement to nursing centers as well as changes in payments for the provision of group rehabilitation therapy services,

- other potential reimbursement changes resulting from the Budget Control Act of 2011,

- the Company s ability to integrate the operations of the acquired hospitals and rehabilitation services operations and realize the anticipated revenues, economies of scale, cost synergies and productivity gains in connection with the RehabCare acquisition and any other acquisitions that may be undertaken during 2011, as and when planned, including the potential for unanticipated issues, expenses and liabilities associated with those acquisitions,

- the potential for diversion of management time and resources in seeking to integrate RehabCare s operations,

- the potential failure to retain key employees of RehabCare,

- the impact of the Company s significantly increased levels of indebtedness as a result of the RehabCare acquisition on the Company s funding costs, operating flexibility and ability to fund ongoing operations, development capital expenditures or other strategic acquisitions with additional borrowings, particularly in light of ongoing volatility in the credit and capital markets,

- the impact of healthcare reform, which will initiate significant reforms to the United States healthcare system, including potential material changes to the delivery of healthcare services and the reimbursement paid for such services by the government or other third party payors. Healthcare reform will impact each of the Company s businesses in some manner. Due to the substantial regulatory changes that will need to be implemented by CMS and others, and the numerous processes required to implement these reforms, the Company cannot predict which healthcare initiatives will be implemented at the federal or state level, the timing of any such reforms, or the effect such reforms or any other future legislation or regulation will have on the Company s business, financial position, results of operations and liquidity,

changes in the reimbursement rates or the methods or timing of payment from third party payors, including commercial payors and the Medicare and Medicaid programs, changes arising from and related to the Medicare prospective payment system for LTAC hospitals, including potential changes in

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

**Cautionary Statement (Continued)**

the Medicare payment rules, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and changes in Medicare and Medicaid reimbursements for nursing centers, and the expiration of the Medicare Part B therapy cap exception process,

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

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

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 moratorium on future hospital development,

the impact of the expiration of several moratoriums under the SCHIP Extension Act which could impact the short stay rules, the budget neutrality adjustment as well as implement the policy known as the 25 Percent Rule, which would limit certain patient admissions,

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

the further consolidation and cost containment efforts 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, Inc.,

the condition of the financial markets, including volatility and weakness 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,

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,

the increase in the costs of defending and insuring against alleged professional liability and other claims and the 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 and other claims,

the Company s ability to successfully dispose of unprofitable facilities,

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

changes in generally accepted accounting principles or practices, and changes in tax accounting or tax laws (or authoritative interpretations relating to any of these matters), and

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

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

**Cautionary Statement (Continued)**

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 LTAC hospitals, inpatient rehabilitation hospitals, nursing and rehabilitation centers, assisted living facilities and a contract rehabilitation services business across the United States. At June 30, 2011, the Company s hospital division operated 120 LTAC hospitals (8,609 licensed beds) and five inpatient rehabilitation hospitals (183 licensed beds) in 26 states. The Company s nursing center division operated 224 nursing and rehabilitation centers and six assisted living facilities (27,585 licensed beds) in 27 states. The Company s rehabilitation division provided rehabilitative services primarily in hospital and long-term care settings in 46 states.

*RehabCare acquisition*

On June 1, 2011, the Company completed the Merger. Upon consummation of the Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive the Merger Consideration. Kindred issued approximately 12 million shares of its common stock in connection with the Merger. The purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of Kindred common stock at fair value. The Company also assumed $356 million of long-term debt in the Merger, of which $345 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in the accompanying unaudited condensed consolidated financial statements of the Company since June 1, 2011. RehabCare reported consolidated revenues of approximately $1.3 billion and net income from continuing operations of approximately $65 million in fiscal 2010.

Operating results for the second quarter of 2011 include transaction costs totaling $19 million, financing costs totaling $12 million and severance costs totaling $15 million related to the Merger. Operating results for the six months ended June 30, 2011 include transaction costs totaling $23 million, financing costs totaling $14 million and severance costs totaling $15 million related to the Merger.

*Vista acquisition*

On November 1, 2010, the Company completed the acquisition of five LTAC hospitals from Vista Healthcare, LLC ( Vista ) for a purchase price of $179 million in cash (the Vista Acquisition ). The Vista Acquisition was financed with proceeds from the Company s former revolving credit facility.

The Vista Acquisition included four freestanding hospitals and one hospital-in-hospital with a total of 250 beds, all of which are located in southern California. The Company did not acquire the working capital of Vista or assume any of its liabilities. All of the Vista hospitals are leased.

*Discontinued operations*

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 or losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed

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

**General (Continued)**

*Discontinued operations (Continued)*

consolidated statement of operations for all periods presented. Assets not sold at June 30, 2011 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 contingencies. The Company relies on historical experience and 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.

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.

*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 $8 million and $6 million for the second quarter of 2011 and 2010, respectively, and $14 million and $12 million for the six months ended June 30, 2011 and 2010, respectively.

*Allowances for insurance risks*

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

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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)*

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 1% to 5% depending upon the policy year. The discount rate was 1% for the 2011 and 2010 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. The allowance for professional liability risks aggregated $269 million at June 30, 2011 and $249 million at December 31, 2010. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $272 million at June 30, 2011 and $253 million at December 31, 2010.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $3 million and $22 million during the six months ended June 30, 2011 and 2010, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s former revolving credit facility.

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 June 30, 2011 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 $17 million and $16 million for the second quarter of 2011 and 2010, respectively, and $35 million and $33 million for the six months ended June 30, 2011 and 2010, respectively.

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 $98 million at June 30, 2011 and $84 million December 31, 2010. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $14 million and $11 million for the second quarter of 2011 and 2010, respectively, and $27 million and $22 million for the six months ended June 30, 2011 and 2010, 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

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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)*

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 was 34.3% and 41.0% for the second quarter of 2011 and 2010, respectively, and 43.6% and 41.1% for the six months ended June 30, 2011 and 2010, respectively. The variances in the effective income tax rates for both 2011 periods compared to the same periods in 2010 primarily related to the impact of lower pretax earnings and the impact of the nondeductible income tax treatment of certain transaction costs incurred in connection with the Merger. The Company expects to record a favorable income tax adjustment of $3 million in the third quarter of 2011 related to the resolution of certain income tax contingencies for prior tax years.

There are significant uncertainties with respect to capital loss carryforwards that could affect materially 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 liabilities totaling $7 million at June 30, 2011 and net deferred tax assets totaling $102 million at December 31, 2010. The change in net deferred taxes at June 30, 2011 was primarily attributable to the Merger and related fair value adjustments recorded in purchase accounting.

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 July 2011, the Company resolved federal income tax audits for the 2007 through 2009 tax years. 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 finite lived 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 that 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.

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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)*

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 20 years.

As a result of the Merger, the Company acquired finite lived intangible assets consisting of customer relationships ($189 million), a trade name ($17 million) and non-compete agreements ($3 million) with estimated useful lives ranging from two to 15 years.

In accordance with the authoritative 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. Accordingly, the Company has determined that its reporting units are hospitals, nursing and rehabilitation centers, skilled nursing rehabilitation services, hospital rehabilitation services, home health and hospice. The carrying value of goodwill for each of the Company s reporting units at June 30, 2011 and December 31, 2010 follows (in thousands):

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| Hospitals | $ 800,431 | $ 213,200 |
| Nursing and rehabilitation centers | 6,080 | 6,080 |
| Rehabilitation division: | | |
| Skilled nursing rehabilitation services | 125,322 | 3,363 |
| Hospital rehabilitation services | 138,920 | |
| Home health | 18,850 | 11,383 |
| Hospice | 8,394 | 8,394 |
| | $ 1,097,997 | $ 242,420 |

As a result of the Merger, goodwill was preliminarily assigned to the Company s hospital reporting unit ($587 million), skilled nursing rehabilitation services reporting unit ($122 million) and hospital rehabilitation services reporting unit ($139 million).

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 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, 2010. The Company did not believe that any of its reporting units were at risk of failing the step one impairment test at December 31, 2010.

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 flow and

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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)*

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 for each reporting unit 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 Company s indefinite lived intangible assets as of December 31, 2010 consist primarily of certificates of need, which are estimated primarily 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 enterprise. The carrying value of the Company s certificates of need at December 31, 2010 was $66 million. The fair values of the Company s indefinite lived intangible assets are derived from current market data and projections at a facility level 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. At December 31, 2010, the fair value of the Company s certificates of need intangible assets exceeded its carrying value. The Company did not believe that any of its certificates of need were at risk for failing the impairment test at December 31, 2010.

As a result of the Merger, the Company acquired indefinite lived intangible assets consisting of trade names ($115 million), Medicare certifications ($76 million) and certificates of need ($8 million).

The Company has determined that during the six months ended June 30, 2011 there were no events or changes in circumstances since December 31, 2010 requiring an interim impairment test. Although the Company has determined that there was no goodwill or other indefinite lived intangible asset impairments as of June 30, 2011 and December 31, 2010, 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 or declines in the value of the Company s common stock may result in future impairment charges for a portion or all of these assets. Specifically, if the rate of growth of government and commercial revenues earned by the Company s reporting units were to be less than projected or if healthcare reforms were to negatively impact the Company s business, an impairment charge of a portion or all of the assets may be required. 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 July 2011, the FASB issued authoritative guidance related to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain healthcare entities. The provisions of the guidance require healthcare entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess a patient s ability to pay, to present the

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

**Recently Issued Accounting Requirements (Continued)**

provision for bad debts related to those revenues as a deduction from patient service revenue (net of contractual allowances and discounts), as opposed to an operating expense. All other entities would continue to present the provision for bad debts as an operating expense. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011, with early adoption permitted. These amendments should be applied retrospectively to all prior periods presented. The disclosures required should be provided for the period of adoption and subsequent reporting periods. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. Early adoption is permitted, but full retrospective application is required. The adoption of the guidance will not have a material impact on the Company s business, financial position, results of operations or liquidity.

In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in common fair value measurement and disclosure requirements in United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily change the wording used to describe many of the requirements in generally accepted accounting principles for measuring and disclosing information about fair value measurements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2010, the FASB issued authoritative guidance related to goodwill and other intangibles. The provisions of the guidance modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining if it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2010, the FASB issued authoritative guidance related to business combinations. The provisions of the guidance specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during a particular year had occurred as of the beginning of the comparable prior year annual reporting period. Supplemental pro forma disclosures also have been expanded to include a description of the nature and amount of material, non-recurring pro forma adjustments included in the pro forma financial statements. The guidance is effective prospectively for business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In January 2010, the FASB issued authoritative guidance related to fair value measurements and disclosures. The provisions of the guidance require new disclosures related to transfers in and out of Levels 1 and 2 classifications (as described in Note 12). The provisions also require a reconciliation of the activity in Level 3 (as described in Note 12) recurring fair value measurements. Existing disclosures also were expanded to include Level 2 fair value measurement valuation techniques and inputs. The guidance is effective for all interim and annual

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

**Recently Issued Accounting Requirements (Continued)**

reporting periods beginning after December 15, 2009, except for the disclosures for Level 3 activity which is effective for fiscal years beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, have a material impact on the Company s business, financial position, results of operations or liquidity.

**Recent Regulatory Changes**

On July 29, 2011, CMS issued final rules which, among other things, will reduce Medicare payments to nursing centers by 11.1% and change the reimbursement for the provision of group therapy services to Medicare beneficiaries effective October 1, 2011. Management believes that these rules could reduce the Company s annual revenues by approximately $85 million to $95 million in its nursing center business and approximately $10 million to $15 million in its rehabilitation therapy business. In addition, management believes that other technical changes required under the final rules may increase rehabilitation therapy costs by approximately $10 million to $15 million on an annual basis.

In addition, CMS also issued final rules that provided payment increases to inpatient rehabilitation facilities ( IRFs ) and LTAC hospitals. Among other things, CMS indicated that Medicare payment rates for IRFs are expected to increase at an annual rate of 2.2% and LTAC payment rates are expected to rise 2.5%. Based upon its review of the final rules, management believes that the Medicare rate increase for the Company s LTAC hospitals will likely approximate 0.7% in 2012.

**Results of Operations Continuing Operations**

***Hospital division***

Revenues increased 20% in the second quarter of 2011 to $593 million compared to $493 million in the same period in 2010 and increased 15% to $1.2 billion for the six months ended June 30, 2011 from $1.0 billion in the same period in 2010. Revenue growth in both periods was primarily a result of increased volumes from the Merger, the Vista Acquisition, the development of new hospitals and higher reimbursement rates. Same-facility revenues were up 2% for both the second quarter of 2011 and for the six months ended June 30, 2011 compared to the same periods in 2010. Aggregate same-facility admissions were relatively unchanged in the second quarter of 2011 and increased 2% for the six months ended June 30, 2011 compared to the respective prior year periods. Revenues associated with the Merger were $51 million for the second quarter of 2011, while revenues associated with the Vista Acquisition were $39 million and $77 million for the second quarter of 2011 and for the six months ended June 30, 2011, respectively.

Hospital operating margins decreased in the second quarter of 2011 and increased slightly for the six months ended June 30, 2011 compared to the same periods in 2010. The decrease in operating margins in the second quarter of 2011 was primarily as a result of an increase in labor hours per patient day. The increase in operating margins for the six months ended June 30, 2011 was primarily a result of higher reimbursement rates and cost efficiencies associated with volume growth. Operating income associated with the Merger was $11 million for the second quarter of 2011, while operating income associated with the Vista Acquisition was $10 million and $18 million for the second quarter of 2011 and for the six months ended June 30, 2011, respectively.

Hospital wage and benefit costs as a percentage of revenues increased to 46.0% and 45.7% in the second quarter of 2011 and for the six months ended June 30, 2011, respectively, compared to 44.8% and 44.9% for the same periods in 2010. Average hourly wage rates increased 2% in both the second quarter of 2011 and for the six months ended June 30, 2011 compared to the respective prior year periods, while employee benefit costs increased 24% in the second quarter of 2011 and 19% for the six months ended June 30, 2011 compared to the respective prior year periods, primarily as a result of the Merger and the Vista Acquisition.

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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)**

***Hospital division (Continued)***

Professional liability costs were $8 million in the second quarter of both 2011 and 2010, and $17 million and $16 million for the six months ended June 30, 2011 and 2010, respectively.

***Nursing center division***

Revenues increased 5% in the second quarter of 2011 to $569 million compared to $543 million in the same period of 2010 and increased 5% to $1.1 billion for the six months ended June 30, 2011 compared to the same prior year period. Revenue growth in both periods was primarily attributable to growth in admissions and reimbursement rate increases that reflected inflationary adjustments and higher average patient acuity. Aggregate same-facility admissions increased 6% in the second quarter of 2011 and 7% for the six months ended June 30, 2011 compared to the respective prior year periods while aggregate same-facility patient days declined 2% in the second quarter of 2011 and 3% for the six months ended June 30, 2011 compared to the respective prior year periods, primarily as a result of declines in average length of stay.

Nursing center operating margins increased in the second quarter of 2011 and for the six months ended June 30, 2011 compared to the same periods in 2010, primarily as a result of higher reimbursement rates, increases in Medicare and managed care payor mix, and labor efficiencies associated with the growth in admissions. Management expects that operating margins will be significantly reduced as a result of the 2011 CMS rule once implemented on October 1, 2011.

Nursing center wage and benefit costs as a percentage of revenues declined to 47.6% and 47.9% in the second quarter of 2011 and for the six months ended June 30, 2011, respectively, compared to 48.8% and 49.7% for the same periods in 2010. Nursing center wage and benefit costs increased 2% and 1% in the second quarter of 2011 and for the six months ended June 30, 2011, respectively, compared to the same periods in 2010. Average hourly wage rates increased 2% and 3% in the second quarter of 2011 and for the six months ended June 30, 2011, respectively, compared to the same periods in 2010, while employee benefit costs increased 6% and 4% in the second quarter of 2011 and for the six months ended June 30, 2011, respectively, compared to the same periods in 2010.

Professional liability costs were $8 million in the second quarter of both 2011 and 2010, and $17 million and $16 million for the six months ended June 30, 2011 and 2010, respectively.

***Rehabilitation division***

***Skilled nursing rehabilitation services***

Revenues increased 70% in the second quarter of 2011 to $172 million compared to $101 million in the same period of 2010 and increased 47% to $295 million for the six months ended June 30, 2011 from $200 million in the same period in 2010. Revenue growth in both periods was primarily attributable to the Merger, and to a lesser extent, growth in new customers and the volume of services provided to existing customers. Revenues associated with the Merger were $46 million for the second quarter of 2011. Revenues derived from unaffiliated customers aggregated $113 million and $45 million in the second quarter of 2011 and 2010, respectively, and $178 million and $87 million for the six months ended June 30, 2011 and 2010, respectively.

Operating margins declined in both the second quarter of 2011 and for the six months ended June 30, 2011 compared to the same periods of 2010, primarily as a result of the Medicare-related changes in billing for

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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)**

***Rehabilitation division (Continued)***

***Skilled nursing rehabilitation services (Continued)***

concurrent therapy services which became effective October 1, 2010. Management expects that margin pressures resulting from these regulatory changes and the new 2011 CMS rule will continue. Operating income associated with the Merger was $5 million for the second quarter of 2011.

***Hospital rehabilitation services***

Revenues increased 83% in the second quarter of 2011 to $39 million compared to $21 million in the same period of 2010 and increased 45% to $61 million for the six months ended June 30, 2011 from $42 million in the same period in 2010. Revenue growth in both periods was primarily attributable to the Merger, and to a lesser extent, growth in new customers and the volume of services provided to existing customers. Revenues associated with the Merger were $16 million for the second quarter of 2011. Revenues derived from unaffiliated customers aggregated $18 million and $1 million in the second quarter of 2011 and 2010, respectively, and $19 million and $2 million for the six months ended June 30, 2011 and 2010, respectively.

Operating margins declined in both the second quarter of 2011 and for the six months ended June 30, 2011 compared to the same periods of 2010, primarily as a result of costs associated with the start-up of new contracts. Operating income associated with the Merger was $4 million for the second quarter of 2011.

***Corporate overhead***

Operating income for the Company s operating divisions excludes allocations of corporate overhead. These costs aggregated $44 million and $33 million in the second quarter of 2011 and 2010, respectively, and $82 million and $67 million for the six months ended June 30, 2011 and 2010, respectively. The increase in both periods was primarily attributable to the Merger. Corporate overhead associated with the Merger was $3 million for the second quarter of 2011. The Company expects that corporate overhead will decline over the remainder of the year as it realizes certain cost synergies from the Merger. As a percentage of consolidated revenues, corporate overhead totaled 3.4% and 3.0% in the second quarter of 2011 and 2010, respectively, and totaled 3.3% and 3.1% for the six months ended June 30, 2011 and 2010, respectively. Operating results for the six months ended June 30, 2010 included approximately $1 million related to retirement costs.

***Transaction costs***

Operating results for the second quarter of 2011 and for the six months ended June 30, 2011 include transaction costs totaling $20 million and $24 million, respectively, primarily related to the Merger. Operating results for the second quarter of 2011 and for the six months ended June 30, 2011 also include severance costs totaling $15 million related to the Merger. Operating results for the second quarter of 2010 and for the six months ended June 30, 2010 include transaction costs totaling $1 million and $2 million, respectively.

***Capital costs***

Rent expense increased 8% to $96 million in the second quarter of 2011 compared to $89 million in the same period of 2010 and increased 6% to $187 million for the six months ended June 30, 2011 from $178 million in the same period in 2010. The increase in both periods resulted

primarily from the Merger and the Vista Acquisition, contractual inflation and contingent rent increases.

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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)***

Depreciation and amortization increased 27% to $38 million in the second quarter of 2011 compared to $30 million in the same period of 2010 and increased 15% to $71 million for the six months ended June 30, 2011 from $61 million in the same period in 2010. The increase in both periods resulted from the Merger and the Company s ongoing capital expenditure program and hospital development projects.

Interest expense increased to $23 million in the second quarter of 2011 compared to $2 million in the same period of 2010 and increased to $29 million for the six months ended June 30, 2011 from $3 million in the same period in 2010. The increase in both periods was primarily attributable to $12 million and $14 million of Merger related financing costs in the second quarter of 2011 and for the six months ended June 30, 2011, respectively, increased borrowings necessary to finance the Merger and higher interest rates compared to the same periods in 2010.

Investment income related primarily to the Company s insurance subsidiary investments totaled $0.3 million in the second quarter of 2011 compared to investment loss of $0.4 million in the same period of 2010 and investment income totaled $1 million for both the six months ended June 30, 2011 and June 30, 2010. Investment loss for the second quarter of 2010 included a $1 million pretax other-than-temporary impairment of various investments held in the Company s insurance subsidiary investment portfolio. The Company considered the severity and duration of its unrealized losses at June 30, 2011 and the remaining unrealized losses at June 30, 2010 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these investments.

***Consolidated results***

Losses from continuing operations before income taxes aggregated $10 million in the second quarter of 2011 compared to income from continuing operations before income taxes of $27 million in the same period in 2010. Income from continuing operations before income taxes aggregated $28 million for the six months ended June 30, 2011 compared to $53 million in the same period in 2010. Losses from continuing operations aggregated $6 million in the second quarter of 2011 compared to income from continuing operations of $16 million in the same period in 2010. Income from continuing operations aggregated $16 million for the six months ended June 30, 2011 from $31 million in the same period in 2010. Transaction, severance and financing costs primarily related to the Merger negatively impacted the consolidated pretax operating results by $47 million ($30 million net of income taxes) for the second quarter of 2011 and $53 million ($34 million net of income taxes) for the six months ended June 30, 2011. Transaction, severance and retirement costs (unrelated to the Merger) negatively impacted the consolidated pretax operating results by $1 million for the second quarter of 2010 and $5 million ($3 million net of income taxes) for the six months ended June 30, 2010.

**Results of Operations Discontinued Operations**

Income from discontinued operations totaled $0.6 million in the second quarter of 2011 compared to $0.1 million in the second quarter of 2010. Income from discontinued operations totaled $0.4 million for the six months ended June 30, 2011 compared to loss from discontinued operations of $0.1 million for the six months ended June 30, 2010.

The Company recorded a pretax loss of $0.2 million ($0.1 million net of income taxes) for the six months ended June 30, 2010 related to the planned divestiture of discontinued operations.

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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 $51 million for the six months ended June 30, 2011 compared to $83 million for the same period in 2010. Operating cash flows for the six months ended June 30, 2011 were negatively impacted by $88 million ($69 million net of income taxes) of transaction, severance and financing payments, primarily related to the Merger. Transaction, severance and retirement payments (unrelated to the Merger) for the six months ended June 30, 2010 were $4 million ($2 million net of income taxes). Operating cash flows also were negatively impacted by lower accounts receivable collections for the six months ended June 30, 2011 compared to the same period in 2010, primarily as a result of temporary billing delays caused by information systems conversions related to the Merger. Operating cash flows in both periods were favorably impacted by federal income tax refunds of $25 million and $10 million for the six months ended June 30, 2011 and 2010, respectively. During the six months ended June 30, 2011, the Company maintained sufficient liquidity to finance its routine capital expenditures, ongoing development programs, and acquisition (excluding the Merger) and strategic development activities.

The Company utilizes its ABL Facility to meet working capital needs and finance its acquisition and development activities. As a result, the Company typically carries minimal amounts of cash on its consolidated balance sheet. Based upon the Company s expected operating cash flows and the availability of borrowings under the Company s ABL Facility ($447 million at June 30, 2011), management believes that the Company has the necessary financial resources to satisfy its expected short-term and long-term liquidity needs.

***New credit facilities and notes***

In connection with the Merger, the Company entered into the ABL Facility, the Term Loan Facility and the Notes. The Company used proceeds from the ABL Facility, the Term Loan Facility and the Notes to pay the Merger Consideration, repay all amounts outstanding under Kindred s and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under Kindred s and RehabCare s former credit facilities that were repaid at the Merger closing were $390 million and $345 million, respectively. The ABL Facility and the Term Loan Facility have incremental facility capacity in an aggregate amount between the two facilities of $200 million, subject to meeting certain conditions, including a specified senior secured leverage ratio. In connection with these new credit arrangements, the Company paid $46 million of lender fees related to debt issuance that were capitalized as deferred financing costs and paid $13 million of other financing costs that were included in interest expense.

All obligations under the ABL Facility and the Term Loan Facility are fully and unconditionally guaranteed, subject to certain exceptions, by substantially all of the Company s existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as the Company may determine from time to time in its sole discretion. The Notes are guaranteed by substantially all of the Company s domestic 100% owned subsidiaries.

The agreements governing the ABL Facility, the Term Loan Facility and the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating and financial restrictions on the Company and certain of its subsidiaries. In addition, the Company is required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio. These financing agreements also contain customary affirmative covenants and events of default. The Company was in compliance with the terms of the ABL Facility, the Term Loan Facility and the Notes at June 30, 2011.

*ABL Facility*

The ABL Facility has a five-year tenor and is secured by the First Priority ABL Collateral. The ABL Facility has a second priority lien on substantially all of the other assets and properties of the Company. As of

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

**Liquidity (Continued)**

June 30, 2011, the Company had $190 million outstanding under the ABL Facility. In addition, approximately $13 million of letters of credit were issued under the ABL Facility to backstop outstanding letters of credit previously issued by RehabCare under its terminated credit facility.

Borrowings under the ABL Facility bear interest at a rate per annum equal to the applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. The initial applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. Commencing with the completion of the Company s first fiscal quarter ending after the Merger, the applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

*Term Loan Facility*

The Term Loan Facility has a tenor of seven years and is secured by a first priority lien on substantially all of the Company s assets and properties other than the First Priority ABL Collateral and a second priority lien on the First Priority ABL Collateral. The Term Loan Facility net proceeds totaled $693 million, net of a $7 million original issue discount that will be amortized over the tenor of the Term Loan Facility.

Borrowings under the Term Loan Facility bear interest at a rate per annum equal to an applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The initial applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings.

*Notes*

In connection with the Merger, the Company completed a private placement of the Notes. The Notes bear interest at an annual rate equal to 8.25% and are senior unsecured obligations of the Company and the subsidiary guarantors, ranking *pari passu* with all of their respective existing and future senior unsubordinated indebtedness. The indenture contains certain restrictive covenants that will, among other things, limit the Company and certain of its subsidiaries ability to incur, assume or guarantee additional indebtedness; pay dividends, make distributions or redeem or repurchase stock; restrict dividends, loans or asset transfers from its subsidiaries; sell or otherwise dispose of assets; and enter into transactions with affiliates. These covenants are subject to a number of limitations and exceptions. The indenture also contains customary events of default.

***Other financing activities***

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $3 million and $22 million during the six months ended June 30, 2011 and 2010, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s former revolving credit facility.

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

**Capital Resources**

Excluding the Merger and acquisitions, routine capital expenditures (expenditures necessary to maintain existing facilities that generally do not increase capacity or add services) totaled $59 million for the six months ended June 30, 2011 compared to $40 million for the same period in 2010. Hospital development capital expenditures (primarily new facility construction) totaled $14 million for the six months ended June 30, 2011 compared to $16 million for the same period in 2010. Nursing and rehabilitation center development capital expenditures (primarily the addition of transitional care services for higher acuity patients and new facility construction) totaled $11 million for the six months ended June 30, 2011 compared to $4 million for the same period in 2010. The Company anticipates that routine capital spending for 2011 should approximate $130 million to $135 million, hospital development capital spending should approximate $70 million to $75 million and nursing and rehabilitation center development capital spending should approximate $25 million to $30 million. Management expects that substantially all of these expenditures will be financed through internal sources.

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 June 30, 2011, the estimated cost to complete and equip construction in progress approximated $27 million.

The Merger purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of Kindred common stock.

Excluding the Merger, the Company financed acquisitions with either operating cash flows or revolving credit facility borrowings. These expenditures totaled $18 million for the six months ended June 30, 2011 compared to $49 million for the same period in 2010.

**Other Information**

***Effects of inflation and changing prices***

The Company derives a substantial portion of its revenues from the Medicare and Medicaid programs. 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 and rehabilitation 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.

Various healthcare reform provisions became law when the Patient Protection and Affordable Care Act was enacted on March 23, 2010 and the Healthcare Education and Reconciliation Act was enacted on March 30, 2010 (collectively, the Affordable Care Act (the ACA )). The reforms contained in the ACA will impact each of the Company s businesses in some manner. Several of the reforms are very significant and could ultimately change the nature of the Company s services, the methods of payment for the Company s services and the underlying regulatory environment. The reforms include possible modifications to the conditions of qualification for payment, bundling payments to cover both acute and post-acute care and the imposition of enrollment limitations on new providers. In addition, a primary goal of healthcare reform is to reduce costs, which includes reductions in the reimbursement paid to the Company and other healthcare providers. Moreover, healthcare reform could negatively impact insurance companies, other third party payors, the Company s customers, as well as other

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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)***

healthcare providers, which may in turn negatively impact the Company s business. As such, these healthcare reforms or other similar healthcare reforms could have a material adverse effect on the Company s business, financial position, results of operations and liquidity.

The ACA enacted a series of reductions to the annual market basket payment updates for LTAC hospitals. In addition to specific market basket reductions, Congress has mandated that the annual market basket payment update for a variety of providers, including both LTAC hospitals and nursing centers, be reduced for a productivity adjustment determined by CMS. These productivity adjustments may vary and will be determined annually by CMS. The productivity adjustments for LTAC hospitals and nursing centers are scheduled to be implemented on October 1, 2011.

The Budget Control Act of 2011, enacted on August 2, 2011, increased the United States debt ceiling in connection with deficit reductions over the next ten years. The Budget Control Act of 2011 also establishes a twelve-member joint committee of Congress known as the Joint Select Committee on Deficit Reduction. The goal of the Joint Select Committee on Deficit Reduction is to propose legislation to reduce the United States federal deficit by $1.5 trillion for fiscal years 2012-2021. Reductions in Medicare and Medicaid spending could be included as part of these deficit reduction measures. Moreover, if such legislation is not enacted by December 23, 2011, approximately $1.2 trillion in domestic and defense spending reductions will automatically begin January 1, 2013, split evenly between domestic and defense spending. Payments to Medicare providers would be subject to these automatic spending reductions, subject to a 2% cap. At this time it is unclear how this automatic reduction may be applied to various Medicare healthcare programs. Reductions to Medicare and Medicaid reimbursement from the Budget Control Act of 2011 could have a material adverse effect on the Company s business, financial position, results of operations or liquidity.

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, the average length of stay of fee for service 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) 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;

(5) a three-year moratorium on the application of a one-time budget neutrality adjustment to payment rates to LTAC hospitals under LTAC PPS;

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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)***

(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 policy known as the 25 Percent Rule (described below) 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 co-located hospital 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.

The ACA revised certain provisions of the SCHIP Extension Act. The moratoriums on the establishment of new LTAC hospitals or satellites and bed increases at LTAC hospitals or satellites, the application of a one-time budget neutrality adjustment to rates, the payment reductions due to the very short-stay outlier provisions and application of the 25 Percent Rule to freestanding hospitals have been extended from three years to five years. In addition, the periods during which LTAC hospitals may admit up to 50% of their patients from co-located hospitals and during which LTAC hospitals may admit up to 75% of their patients from a MSA Dominant hospital have been extended from three years to five years as well.

CMS has regulations governing payments to LTAC hospitals that are co-located with another hospital (a HIH ). The rules generally limit Medicare payments to the HIH if the Medicare admissions to the HIH from its co-located hospital exceed 25% of the total Medicare discharges for the HIH s cost reporting period, the 25 Percent Rule. 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 co-located hospital, are eligible for the full payment under LTAC PPS. If the HIH s admissions from the co-located 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 June 30, 2011, the Company operated 31 HIHs with 1,215 licensed beds.

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2007 Final Rule ). In the 2007 Final Rule, the 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 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 IPPS. However, as set forth above, the SCHIP Extension

Act initially placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. That moratorium was extended to five years by the ACA. In addition, the SCHIP Extension Act initially provided for a three-year period during which (1) LTAC hospitals may admit up to 50% of their patients from their co-located hospitals and still be paid according to LTAC PPS; and (2) LTAC hospitals that

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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)***

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. Those periods also were extended to five years under the ACA. The five-year moratorium of the 25 Percent Rule threshold payment adjustment for freestanding hospitals and grandfathered HIHs will expire for cost reporting periods beginning on or after July 1, 2012. The expansion of the admission limit to 50% for non-grandfathered LTAC hospitals from their co-located hospital will expire for cost reports beginning on or after October 1, 2012, the same time at which the 75% limit for MSA Dominant hospitals will expire.

On July 31, 2009, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2009. Included in those final regulations is (1) a market basket increase to the standard federal payment rate of 2.5%; (2) an offset of 0.5% applied to the standard federal payment rate to account for the effect of documentation and coding changes; (3) adjustments to area wage indexes; and (4) a decrease in the high cost outlier threshold per discharge to $18,425. These final regulations also include a recalibration of the diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, MS-LTC-DRGs, payment weights. CMS indicated that all of these changes will result in a 3.3% increase to average Medicare payments to LTAC hospitals. The 2.7% annualized reduction that resulted from a recalibration of MS-LTC-DRG payment weights on June 3, 2009 is incorporated into the final October 1, 2009 payment weights. On April 1, 2010, CMS reduced the October 1, 2009 standard federal payment rate by 0.25% as mandated by the ACA. In addition to specific market basket reductions, Congress has mandated that the annual market basket payment update for a variety of providers, including LTAC hospitals, be reduced for a productivity adjustment determined by CMS. These productivity adjustments may vary and will be determined annually by CMS. The productivity adjustments for LTAC hospitals are scheduled to be implemented on October 1, 2011.

On July 30, 2010, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2010. Included in those final regulations is (1) a market basket increase to the standard federal payment rate of 2.5%; (2) an offset of 2.5% applied to the standard federal payment rate to account for the effect of documentation and coding changes; (3) an offset of 0.5% applied to the standard federal payment rate as mandated by the ACA; (4) adjustments to area wage indexes; and (5) an increase in the high cost outlier threshold per discharge to $18,785. CMS indicated that all of these changes will result in a 0.5% increase to average Medicare payments to LTAC hospitals.

On August 1, 2011, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2011. Included in the final regulations is (1) a market basket increase to the standard federal payment rate of 2.9%; (2) offsets to the standard federal payment rate mandated by the ACA of: (a) 1.0% to account for the effect of a productivity adjustment, and (b) 0.1% as required by statute; (3) a wage level budget neutrality factor of 0.99775 applied to the adjusted standard federal payment rate; (4) adjustments to area wage indexes; and (5) a decrease in the high cost outlier threshold per discharge to $17,931. CMS has projected the impact of these proposed changes will result in a 2.5% increase to average Medicare payments to LTAC hospitals. Management believes that the impact of these proposed changes to LTAC PPS would result in an approximate 0.7% increase in payments to the Company s LTAC hospitals.

On August 2, 2011, the Long-Term Care Hospital Improvement Act of 2011 was introduced into the United States Senate (the LTAC Legislation ). If enacted, the LTAC Legislation would implement new patient and facility criteria for LTAC hospitals and alleviate the negative impact of various scheduled Medicare reimbursement adjustments. The LTAC Legislation provides for patient criteria to ensure that LTAC hospital patients are physician screened prior to admission and throughout their stay for appropriateness of their stay in an

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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)***

LTAC hospital. In addition, facility criteria would establish common requirements for the programmatic, personnel and clinical operations of an LTAC hospital. The LTAC Legislation further provides that at least 70% of patients must be medically complex in order for a hospital to maintain its Medicare certification as a LTAC hospital. The LTAC Legislation also would repeal the 25 Percent Rule for all LTAC hospitals, the scheduled very short-stay outlier payment reductions and the one-time budget neutrality adjustment requirement. There can be no assurances that the LTAC Legislation will be enacted in its current form or at all.

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 commercial third party payors. Various factors, including a reduction in average length of stay, have negatively impacted revenues from commercial third party payors in recent years.

On July 29, 2011, CMS issued final regulations regarding Medicare reimbursement for IRFs for the fiscal year beginning October 1, 2011. Included in those proposed regulations is (1) a market basket increase to the standard payment conversion factor of 2.9%; (2) offsets to the standard payment conversion factor mandated by the ACA of: (a) 1.0% to account for the effect of a productivity adjustment, and (b) 0.1% as required by statute; (3) a wage level budget neutrality factor of 0.9988 applied to the standard payment conversion factor; (4) a case mix group budget neutrality factor of 0.9988 applied to the standard payment conversion factor; (5) adjustments to area wage indexes; and (6) a decrease in the high cost outlier threshold per discharge to $10,660. CMS has projected the impact of these proposed changes will result in a 2.2% increase to average Medicare payments to IRFs.

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 groups ( 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 and rehabilitation centers of 1.1%. In addition to specific market basket reductions, Congress has mandated that the annual market basket payment update for a variety of providers, including nursing centers, be reduced for a productivity adjustment determined by CMS. These productivity adjustments may vary and will be determined annually by CMS. The productivity adjustments for nursing centers are scheduled to be implemented on October 1, 2011.

On July 16, 2010, CMS issued a notice that updates the payment rates for nursing centers for the fiscal year beginning October 1, 2010. That notice provided for an increase in rates of 1.7%, which is comprised of a market basket increase of 2.3% less a forecast error adjustment of 0.6%.

In addition, for the fiscal year beginning October 1, 2010, CMS finalized provisions that increase the number of RUG categories for nursing centers from 53 to 66 (i.e., RUGs IV) and amend the criteria, including the provision of therapy services, used to classify patients into these categories. CMS has indicated that these changes will be enacted in a budget neutral manner.

The therapy time requirements to qualify for rehabilitation RUG categories are unchanged under RUGs IV, however the allocation of minutes has changed as a result of the most recent clinical assessment tool of the minimum data set ( MDS 3.0 ). Rather than count all therapy time that a nursing center patient receives,

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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)***

rehabilitation providers must now allocate therapy minutes between the patients being served during concurrent therapy sessions. In addition, the number of patients that a therapist/assistant may treat concurrently is limited to two patients. Additional tracking provisions also require therapists to track and report different delivery modes of therapy (individual, concurrent and group therapy) on MDS 3.0. The Company s rehabilitation division has hired additional therapists to facilitate the provision of additional individual minutes. Effective October 1, 2010, CMS began paying claims using the RUGs IV system.

CMS issued a final rule on July 29, 2011 updating Medicare payment rates for skilled nursing centers effective October 1, 2011. The final rule imposes (1) a negative adjustment to RUGs IV therapy rates, and (2) a net market basket increase of 1.7% consisting of (a) a 2.7% market basket inflation increase, less (b) a 1.0% adjustment to account for the effect of a productivity adjustment, beginning on October 1, 2011. CMS has projected the impact of these changes will result in an 11.1% decrease in payments to skilled nursing centers. Under the final rule, group therapy would be defined as therapy sessions with four patients who are performing similar therapy activities. In addition, for purposes of assigning patients to RUGs IV payment categories, the minutes of group therapy would be allocated based upon the number of patients in the therapy session, consistent with the rules for concurrent therapy that have been in place since October 1, 2010. The final rule also clarifies circumstances for reporting breaks of three or more days of therapy and implements a new change of therapy assessment to capture those changes in a patient s therapy status that would be sufficient to affect the RUGs IV classification and payment. Management believes that these rules could reduce the Company s annual revenues by approximately $85 million to $95 million in its nursing center business and approximately $10 million to $15 million in its rehabilitation therapy business. In addition, management believes that other technical changes required under the final rules may increase rehabilitation therapy costs by approximately $10 million to $15 million on an annual basis.

On November 2, 2010, CMS issued a final rule related to rate changes to Medicare Part B therapy services included in the Medicare Physician Fee Schedule ( MPFS ) rule. The rule became effective January 1, 2011. The rule provides for a rate reduction for reimbursement of therapy expenses for secondary procedures when multiple therapy services are provided on the same day. CMS projects that the rule will result in an approximate 7% rate reduction for Medicare Part B therapy services in calendar year 2011. Based upon the Company s historical Medicare Part B therapy services data, the Company estimates that this rule will reduce its Medicare revenues related to Part B therapy services by approximately $7 million per year beginning in 2011.

Medicare Part B provides reimbursement for certain physician services, limited drug coverage and other outpatient services, such as therapy and other services, outside of a Medicare Part A covered patient stay. Payment for these services is determined according to MPFS. Annually since 1997, the MPFS has been subject to a sustainable growth rate adjustment ( SGR ) intended to keep spending growth in line with allowable spending. Each year since the SGR was enacted, this adjustment produced a scheduled negative update to payment for physicians, therapists and other healthcare providers paid under the MPFS. Annually, since 2002, Congress has stepped in with so-called doc fix legislation to stop payment cuts to physicians. In December 2010, Congress passed the Medicare and Medicaid Extenders Act of 2010 ( MMEA ) which again suspended the payment cut for 2011.

Since 2006, federal legislation has provided for an annual Medicare Part B outpatient therapy cap. In succeeding years, CMS subsequently increased the amount of the therapy cap. Legislation also was passed that required CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. Legislation has annually extended the Medicare Part B outpatient therapy cap exception

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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)***

process. 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 ACA provided that the exception process remain in effect from January 1, 2010 through December 31, 2010. MMEA extended the therapy cap exception process through December 31, 2011.

The Company believes that its operating margins may continue to be under pressure as the growth in operating expenses, particularly professional liability, labor and employee benefits costs, exceeds payment increases from 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.

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**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)**

| | 2010 Quarters | | | | 2011 Quarters | |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second |
| Revenues | $ 1,089,837 | $ 1,081,364 | $ 1,053,012 | $ 1,135,484 | $ 1,192,421 | $ 1,292,592 |
| Salaries, wages and benefits | 627,175 | 612,205 | 613,607 | 652,703 | 678,695 | 765,133 |
| Supplies | 85,886 | 85,455 | 83,753 | 87,103 | 90,022 | 96,718 |
| Rent | 88,319 | 88,981 | 89,295 | 90,777 | 91,453 | 95,677 |
| Other operating expenses | 234,204 | 238,687 | 234,968 | 240,750 | 259,369 | 287,132 |
| Other income | (3,084) | (2,857) | (2,794) | (2,687) | (2,785) | (2,880) |
| Depreciation and amortization | 31,121 | 29,852 | 29,167 | 31,412 | 32,549 | 37,871 |
| Interest expense | 1,307 | 1,298 | 1,642 | 2,843 | 5,728 | 23,157 |
| Investment (income) loss | (877) | 377 | (403) | (342) | (495) | (257) |
| | 1,064,051 | 1,053,998 | 1,049,235 | 1,102,559 | 1,154,536 | 1,302,551 |
| Income (loss) from continuing operations before income taxes | 25,786 | 27,366 | 3,777 | 32,925 | 37,885 | (9,959) |
| Provision (benefit) for income taxes | 10,631 | 11,230 | (1,323) | 13,170 | 15,609 | (3,419) |
| Income (loss) from continuing operations | 15,155 | 16,136 | 5,100 | 19,755 | 22,276 | (6,540) |
| Discontinued operations, net of income taxes: | | | | | | |
| Income (loss) from operations | (154) | 87 | (260) | 1,125 | (179) | 587 |
| Gain (loss) on divestiture of operations | (137) | 54 | 86 | (456) | | |
| Income (loss) from discontinued operations | (291) | 141 | (174) | 669 | (179) | 587 |
| Net income (loss) | 14,864 | 16,277 | 4,926 | 20,424 | 22,097 | (5,953) |
| Loss attributable to noncontrolling interest | | | | | | 421 |
| Income (loss) attributable to Kindred | $ 14,864 | $ 16,277 | $ 4,926 | $ 20,424 | $ 22,097 | $ (5,532) |
| Amounts attributable to Kindred stockholders: | | | | | | |
| Income (loss) from continuing operations | $ 15,155 | $ 16,136 | $ 5,100 | $ 19,755 | $ 22,276 | $ (6,119) |
| Income (loss) from discontinued operations | (291) | 141 | (174) | 669 | (179) | 587 |
| Income (loss) attributable to Kindred | $ 14,864 | $ 16,277 | $ 4,926 | $ 20,424 | $ 22,097 | $ (5,532) |
| Earnings (loss) per common share: | | | | | | |
| Basic: | | | | | | |
| Income (loss) from continuing operations | $ 0.38 | $ 0.41 | $ 0.13 | $ 0.50 | $ 0.56 | $ (0.14) |
| Discontinued operations: | | | | | | |
| Income (loss) from operations | | | (0.01) | 0.03 | | 0.01 |
| Gain (loss) on divestiture of operations | | | | (0.01) | | |
| Net income (loss) | $ 0.38 | $ 0.41 | $ 0.12 | $ 0.52 | $ 0.56 | $ (0.13) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Diluted: | | | | | | |
| Income (loss) from continuing operations | $ 0.38 | $ 0.41 | $ 0.13 | $ 0.50 | $ 0.55 | $ (0.14) |
| Discontinued operations: | | | | | | |
| Income (loss) from operations | | | (0.01) | 0.03 | | 0.01 |
| Gain (loss) on divestiture of operations | | | | (0.01) | | |
| Net income (loss) | $ 0.38 | $ 0.41 | $ 0.12 | $ 0.52 | $ 0.55 | $ (0.13) |
| Shares used in computing earnings (loss) per common share: | | | | | | |
| Basic | 38,626 | 38,756 | 38,778 | 38,790 | 39,035 | 43,231 |
| Diluted | 38,859 | 38,914 | 38,838 | 39,089 | 39,543 | 43,231 |

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

**Operating Data**

**(Unaudited)**

**(In thousands)**

| | 2010 Quarters | | | | 2011 Quarters | |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second |
| **Revenues:** | | | | | | |
| Hospital division | $ 507,062 | $ 493,401 | $ 465,198 | $ 507,660 | $ 558,974 | $ 593,425 |
| Nursing center division | 539,321 | 542,215 | 539,914 | 566,435 | 567,472 | 568,199 |
| Rehabilitation division: | | | | | | |
| Skilled nursing rehabilitation services | 98,997 | 101,148 | 103,807 | 117,325 | 122,656 | 172,074 |
| Hospital rehabilitation services | 21,147 | 20,913 | 20,436 | 21,182 | 22,490 | 38,291 |
| | 120,144 | 122,061 | 124,243 | 138,507 | 145,146 | 210,365 |
| | 1,166,527 | 1,157,677 | 1,129,355 | 1,212,602 | 1,271,592 | 1,371,989 |
| Eliminations | (76,690) | (76,313) | (76,343) | (77,118) | (79,171) | (79,397) |
| | $ 1,089,837 | $ 1,081,364 | $ 1,053,012 | $ 1,135,484 | $ 1,192,421 | $ 1,292,592 |
| **Income (loss) from continuing operations:** | | | | | | |
| Operating income (loss): | | | | | | |
| Hospital division | $ 95,440 | $ 91,790 | $ 75,784 | $ 97,343 | $ 108,385 | $ 108,465 |
| Nursing center division | 70,614 | 76,529 | 69,363 | 86,912 | 87,350 | 93,532 |
| Rehabilitation division: | | | | | | |
| Skilled nursing rehabilitation services | 9,537 | 9,307 | 9,486 | 5,307 | 9,149 | 15,531 |
| Hospital rehabilitation services | 5,146 | 4,793 | 4,728 | 4,302 | 5,332 | 8,033 |
| | 14,683 | 14,100 | 14,214 | 9,609 | 14,481 | 23,564 |
| Corporate: | | | | | | |
| Overhead | (33,831) | (32,799) | (34,329) | (33,002) | (38,315) | (43,801) |
| Insurance subsidiary | (480) | (791) | (783) | (1,099) | (602) | (420) |
| | (34,311) | (33,590) | (35,112) | (34,101) | (38,917) | (44,221) |
| Transaction costs (a) | (770) | (955) | (771) | (2,148) | (4,179) | (34,851) |
| Operating income | 145,656 | 147,874 | 123,478 | 157,615 | 167,120 | 146,489 |
| Rent | (88,319) | (88,981) | (89,295) | (90,777) | (91,453) | (95,677) |
| Depreciation and amortization | (31,121) | (29,852) | (29,167) | (31,412) | (32,549) | (37,871) |
| Interest, net | (430) | (1,675) | (1,239) | (2,501) | (5,233) | (22,900)(b) |
| Income (loss) from continuing operations before income taxes | 25,786 | 27,366 | 3,777 | 32,925 | 37,885 | (9,959) |
| Provision (benefit) for income taxes | 10,631 | 11,230 | (1,323) | 13,170 | 15,609 | (3,419) |

| | | | | | | |
|---|---|---|---|---|---|---|
| $ 15,155 | $ 16,136 | $ 5,100 | $ 19,755 | $ 22,276 | $ (6,540) |

(a) Transaction-related charges for the 2010 periods have been reclassified to conform with the current period presentation.
(b) Includes $11.8 million of financing costs associated with the Merger.

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

**Operating Data (Continued)**

**(Unaudited)**

**(In thousands)**

| | 2010 Quarters | | | | 2011 Quarters | |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second |
| **Rent:** | | | | | | |
| Hospital division | $ 37,415 | $ 38,043 | $ 38,122 | $ 39,406 | $ 40,299 | $ 43,997 |
| Nursing center division | 49,392 | 49,439 | 49,627 | 49,647 | 49,384 | 49,562 |
| Rehabilitation division: | | | | | | |
| Skilled nursing rehabilitation services | 1,449 | 1,445 | 1,474 | 1,662 | 1,698 | 1,791 |
| Hospital rehabilitation services | 26 | 25 | 28 | 27 | 28 | 33 |
| | 1,475 | 1,470 | 1,502 | 1,689 | 1,726 | 1,824 |
| Corporate | 37 | 29 | 44 | 35 | 44 | 294 |
| | $ 88,319 | $ 88,981 | $ 89,295 | $ 90,777 | $ 91,453 | $ 95,677 |
| **Depreciation and amortization:** | | | | | | |
| Hospital division | $ 13,014 | $ 12,549 | $ 12,655 | $ 13,421 | $ 14,278 | $ 16,572 |
| Nursing center division | 12,113 | 11,185 | 10,527 | 11,646 | 11,793 | 13,038 |
| Rehabilitation division: | | | | | | |
| Skilled nursing rehabilitation services | 523 | 558 | 591 | 731 | 759 | 1,339 |
| Hospital rehabilitation services | 62 | 68 | 77 | 99 | 97 | 819 |
| | 585 | 626 | 668 | 830 | 856 | 2,158 |
| Corporate | 5,409 | 5,492 | 5,317 | 5,515 | 5,622 | 6,103 |
| | $ 31,121 | $ 29,852 | $ 29,167 | $ 31,412 | $ 32,549 | $ 37,871 |
| **Capital expenditures, excluding acquisitions (including discontinued operations):** | | | | | | |
| Hospital division: | | | | | | |
| Routine | $ 6,065 | $ 7,954 | $ 9,113 | $ 13,835 | $ 12,144 | $ 11,809 |
| Development | 5,774 | 10,209 | 12,900 | 12,257 | 7,777 | 6,423 |
| | 11,839 | 18,163 | 22,013 | 26,092 | 19,921 | 18,232 |
| Nursing center division: | | | | | | |
| Routine | 4,049 | 9,135 | 11,548 | 12,292 | 8,155 | 8,000 |
| Development | 1,793 | 2,079 | 7,464 | 15,365 | 3,322 | 7,705 |
| | 5,842 | 11,214 | 19,012 | 27,657 | 11,477 | 15,705 |
| Rehabilitation division: | | | | | | |
| Skilled nursing rehabilitation services: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Routine | 228 | 258 | 328 | 1,608 | 255 | 217 |
| Development | | | | | 10 | 181 |
| | 228 | 258 | 328 | 1,608 | 265 | 398 |
| Hospital rehabilitation services: | | | | | | |
| Routine | 39 | 23 | 23 | 208 | 25 | 72 |
| Development | | | | | | |
| | 39 | 23 | 23 | 208 | 25 | 72 |
| Corporate: | | | | | | |
| Information systems | 4,146 | 7,853 | 6,625 | 11,162 | 3,932 | 13,641 |
| Other | 288 | 447 | 986 | 683 | 207 | 211 |
| | $ 22,382 | $ 37,958 | $ 48,987 | $ 67,410 | $ 35,827 | $ 48,259 |

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

**Condensed Consolidating Statement of Operations**

**(Unaudited)**

**(In thousands)**

| | Second quarter 2011 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Rehabilitation division | | | | | | | | |
| | Hospital division | Nursing center division | Skilled nursing services | Hospital services | Total | Corporate | Transaction costs | Eliminations | Consolidated |
| Revenues | $ 593,425 | $ 568,199 | $ 172,074 | $ 38,291 | $ 210,365 | $ | $ | $ (79,397) | $ 1,292,592 |
| Salaries, wages and benefits | 273,260 | 270,347 | 148,236 | 28,086 | 176,322 | 30,354 | 14,866 | (16) | 765,133 |
| Supplies | 67,612 | 27,870 | 1,006 | 37 | 1,043 | 193 | | | 96,718 |
| Rent | 43,997 | 49,562 | 1,791 | 33 | 1,824 | 294 | | | 95,677 |
| Other operating expenses | 144,088 | 176,450 | 7,301 | 2,135 | 9,436 | 16,554 | 19,985 | (79,381) | 287,132 |
| Other income | | | | | | (2,880) | | | (2,880) |
| Depreciation and amortization | 16,572 | 13,038 | 1,339 | 819 | 2,158 | 6,103 | | | 37,871 |
| Interest expense | 66 | 22 | | | | 11,266 | 11,803 | | 23,157 |
| Investment income | (2) | (20) | (1) | | (1) | (234) | | | (257) |
| | 545,593 | 537,269 | 159,672 | 31,110 | 190,782 | 61,650 | 46,654 | (79,397) | 1,302,551 |
| Income (loss) from continuing operations before income taxes | $ 47,832 | $ 30,930 | $ 12,402 | $ 7,181 | $ 19,583 | $ (61,650) | $ (46,654) | $ | (9,959) |
| Provision (benefit) for income taxes | | | | | | | | | (3,419) |
| Income (loss) from continuing operations | | | | | | | | | $ (6,540) |

| | Second quarter 2010 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Rehabilitation division | | | | | | | | |
| | Hospital division | Nursing center division | Skilled nursing services | Hospital services | Total | Corporate | Transaction costs | Eliminations | Consolidated |
| Revenues | $ 493,401 | $ 542,215 | $ 101,148 | $ 20,913 | $ 122,061 | $ | $ | $ (76,313) | $ 1,081,364 |
| Salaries, wages and benefits | 221,086 | 264,653 | 86,551 | 15,431 | 101,982 | 24,484 | | | 612,205 |
| Supplies | 57,150 | 27,448 | 704 | 22 | 726 | 131 | | | 85,455 |
| Rent | 38,043 | 49,439 | 1,445 | 25 | 1,470 | 29 | | | 88,981 |
| Other operating expenses | 123,375 | 173,585 | 4,586 | 667 | 5,253 | 11,832 | 955 | (76,313) | 238,687 |
| Other income | | | | | | (2,857) | | | (2,857) |
| Depreciation and amortization | 12,549 | 11,185 | 558 | 68 | 626 | 5,492 | | | 29,852 |
| Interest expense | 1 | 29 | | | | 1,268 | | | 1,298 |
| Investment (income) loss | | (17) | (2) | (1) | (3) | 397 | | | 377 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 452,204 | 526,322 | 93,842 | 16,212 | 110,054 | 40,776 | 955 | (76,313) | 1,053,998 |
| Income (loss) from continuing operations before income taxes | $ 41,197 | $ 15,893 | $ 7,306 | $ 4,701 | $ 12,007 | $ (40,776) | $ (955) | $ | 27,366 |
| Provision (benefit) for income taxes | | | | | | | | | 11,230 |
| Income (loss) from continuing operations | | | | | | | | | $ 16,136 |

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

**Condensed Consolidating Statement of Operations (Continued)**

**(Unaudited)**

**(In thousands)**

| | Six months ended June 30, 2011 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Rehabilitation division | | | | | | | |
| | Hospital division | Nursing center division | Skilled nursing services | Hospital services | Total | Corporate | Transaction costs | Eliminations | Consolidated |
| Revenues | $ 1,152,399 | $ 1,135,671 | $ 294,730 | $ 60,781 | $ 355,511 | $ | $ | $ (158,568) | $ 2,485,013 |
| Salaries, wages and benefits | 526,322 | 543,517 | 256,419 | 44,734 | 301,153 | 58,020 | 14,866 | (50) | 1,443,828 |
| Supplies | 129,459 | 54,995 | 1,890 | 60 | 1,950 | 336 | | | 186,740 |
| Rent | 84,296 | 98,946 | 3,489 | 61 | 3,550 | 338 | | | 187,130 |
| Other operating expenses | 279,768 | 356,277 | 11,741 | 2,622 | 14,363 | 30,447 | 24,164 | (158,518) | 546,501 |
| Other income | | | | | | (5,665) | | | (5,665) |
| Depreciation and amortization | 30,850 | 24,831 | 2,098 | 916 | 3,014 | 11,725 | | | 70,420 |
| Interest expense | 66 | 51 | | | | 14,966 | 13,802 | | 28,885 |
| Investment income | (3) | (40) | (2) | | (2) | (707) | | | (752) |
| | 1,050,758 | 1,078,577 | 275,635 | 48,393 | 324,028 | 109,460 | 52,832 | (158,568) | 2,457,087 |
| Income (loss) from continuing operations before income taxes | $ 101,641 | $ 57,094 | $ 19,095 | $ 12,388 | $ 31,483 | $ (109,460) | $ (52,832) | $ | 27,926 |
| Provision (benefit) for income taxes | | | | | | | | | 12,190 |
| Income (loss) from continuing operations | | | | | | | | | $ 15,736 |

| | Six months ended June 30, 2010 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Rehabilitation division | | | | | | | |
| | Hospital division(a) | Nursing center division(a) | Skilled nursing services | Hospital services | Total | Corporate(a) | Transaction costs | Eliminations | Consolidated |
| Revenues | $ 1,000,463 | $ 1,081,536 | $ 200,145 | $ 42,060 | $ 242,205 | $ | $ | $ (153,003) | $ 2,171,201 |
| Salaries, wages and benefits | 448,727 | 537,895 | 171,574 | 30,920 | 202,494 | 50,264 | | | 1,239,380 |
| Supplies | 115,084 | 54,576 | 1,370 | 43 | 1,413 | 268 | | | 171,341 |
| Rent | 75,458 | 98,831 | 2,894 | 51 | 2,945 | 66 | | | 177,300 |
| Other operating expenses | 249,422 | 341,922 | 8,357 | 1,158 | 9,515 | 23,310 | 1,725 | (153,003) | 472,891 |
| Other income | | | | | | (5,941) | | | (5,941) |
| Depreciation and amortization | 25,563 | 23,298 | 1,081 | 130 | 1,211 | 10,901 | | | 60,973 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Interest expense | 3 | 60 | | | | 2,542 | | | 2,605 |
| Investment income | (1) | (35) | (3) | (1) | (4) | (460) | | | (500) |
| | 914,256 | 1,056,547 | 185,273 | 32,301 | 217,574 | 80,950 | 1,725 | (153,003) | 2,118,049 |
| Income (loss) from continuing operations before income taxes | $ 86,207 | $ 24,989 | $ 14,872 | $ 9,759 | $ 24,631 | $ (80,950) | $ (1,725) | $ | 53,152 |
| Provision (benefit) for income taxes | | | | | | | | | 21,861 |
| Income (loss) from continuing operations | | | | | | | | | $ 31,291 |

(a) Includes $2.9 million in aggregate of severance and retirement costs in salaries, wages and benefits (Hospital division $1.1 million, Nursing center division $0.5 million and Corporate $1.3 million).

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

**Operating Data**

**(Unaudited)**

| | 2010 Quarters | | | | 2011 Quarters | |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second |
| **Hospital data:** | | | | | | |
| End of period data: | | | | | | |
| Number of hospitals: | | | | | | |
| Long-term acute care | 83 | 83 | 83 | 89 | 89 | 120 |
| Inpatient rehabilitation | | | | | | 5 |
| | 83 | 83 | 83 | 89 | 89 | 125 |
| Number of licensed beds: | | | | | | |
| Long-term acute care | 6,580 | 6,576 | 6,563 | 6,887 | 6,889 | 8,609 |
| Inpatient rehabilitation | | | | | | 183 |
| | 6,580 | 6,576 | 6,563 | 6,887 | 6,889 | 8,792 |
| Revenue mix %: | | | | | | |
| Medicare | 56 | 56 | 55 | 58 | 60 | 60 |
| Medicaid | 9 | 9 | 9 | 9 | 8 | 8 |
| Medicare Advantage | 10 | 10 | 10 | 9 | 10 | 10 |
| Commercial insurance and other | 25 | 25 | 26 | 24 | 22 | 22 |
| Admissions: | | | | | | |
| Medicare | 7,432 | 7,125 | 6,769 | 7,640 | 8,504 | 8,913 |
| Medicaid | 997 | 990 | 1,022 | 1,034 | 1,085 | 1,163 |
| Medicare Advantage | 1,129 | 1,106 | 936 | 1,071 | 1,172 | 1,348 |
| Commercial insurance and other | 2,262 | 2,048 | 1,978 | 2,020 | 2,282 | 2,290 |
| | 11,820 | 11,269 | 10,705 | 11,765 | 13,043 | 13,714 |
| Admissions mix %: | | | | | | |
| Medicare | 63 | 63 | 63 | 65 | 65 | 65 |
| Medicaid | 8 | 9 | 10 | 9 | 8 | 8 |
| Medicare Advantage | 10 | 10 | 9 | 9 | 9 | 10 |
| Commercial insurance and other | 19 | 18 | 18 | 17 | 18 | 17 |
| Patient days: | | | | | | |
| Medicare | 202,882 | 195,964 | 179,324 | 198,129 | 219,213 | 237,257 |
| Medicaid | 47,813 | 45,952 | 48,514 | 46,596 | 45,650 | 45,746 |
| Medicare Advantage | 34,524 | 36,000 | 31,186 | 32,868 | 35,639 | 39,503 |
| Commercial insurance and other | 75,483 | 70,651 | 70,198 | 69,585 | 70,522 | 72,759 |
| | 360,702 | 348,567 | 329,222 | 347,178 | 371,024 | 395,265 |
| Average length of stay: | | | | | | |
| Medicare | 27.3 | 27.5 | 26.5 | 25.9 | 25.8 | 26.6 |
| Medicaid | 48.0 | 46.4 | 47.5 | 45.1 | 42.1 | 39.3 |
| Medicare Advantage | 30.6 | 32.5 | 33.3 | 30.7 | 30.4 | 29.3 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Commercial insurance and other | 33.4 | 34.5 | 35.5 | 34.4 | 30.9 | 31.8 |
| Weighted average | 30.5 | 30.9 | 30.8 | 29.5 | 28.4 | 28.8 |
| Revenues per admission: | | | | | | |
| Medicare | $ 38,078 | $ 38,938 | $ 37,675 | $ 38,368 | $ 39,439 | $ 40,089 |
| Medicaid | 45,738 | 42,774 | 42,910 | 41,704 | 42,432 | 41,576 |
| Medicare Advantage | 45,187 | 46,169 | 48,122 | 44,744 | 46,217 | 42,708 |
| Commercial insurance and other | 56,344 | 59,842 | 61,314 | 61,131 | 54,065 | 56,850 |
| Weighted average | 42,899 | 43,784 | 43,456 | 43,150 | 42,856 | 43,271 |
| Revenues per patient day: | | | | | | |
| Medicare | $ 1,395 | $ 1,416 | $ 1,422 | $ 1,479 | $ 1,530 | $ 1,506 |
| Medicaid | 954 | 922 | 904 | 925 | 1,009 | 1,057 |
| Medicare Advantage | 1,478 | 1,418 | 1,444 | 1,458 | 1,520 | 1,457 |
| Commercial insurance and other | 1,688 | 1,735 | 1,728 | 1,775 | 1,749 | 1,789 |
| Weighted average | 1,406 | 1,416 | 1,413 | 1,462 | 1,507 | 1,501 |
| Medicare case mix index (discharged patients only) | 1.21 | 1.21 | 1.19 | 1.17 | 1.21 | 1.22 |
| Average daily census | 4,008 | 3,830 | 3,579 | 3,774 | 4,122 | 4,344 |
| Occupancy % | 68.2 | 66.1 | 62.0 | 64.0 | 68.7 | 65.5 |
| Annualized employee turnover % | 21.8 | 22.6 | 22.3 | 22.0 | 21.2 | 22.1 |

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

**Operating Data (Continued)**

**(Unaudited)**

| | 2010 Quarters | | | | 2011 Quarters | |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second |
| **Nursing and rehabilitation center data:** | | | | | | |
| End of period data: | | | | | | |
| Number of facilities: | | | | | | |
| Nursing and rehabilitation centers: | | | | | | |
| Owned or leased | 218 | 219 | 222 | 222 | 220 | 220 |
| Managed | 4 | 4 | 4 | 4 | 4 | 4 |
| Assisted living facilities | 6 | 7 | 7 | 7 | 6 | 6 |
| | 228 | 230 | 233 | 233 | 230 | 230 |
| Number of licensed beds: | | | | | | |
| Nursing and rehabilitation centers: | | | | | | |
| Owned or leased | 26,711 | 26,760 | 27,030 | 26,957 | 26,767 | 26,687 |
| Managed | 485 | 485 | 485 | 485 | 485 | 485 |
| Assisted living facilities | 327 | 463 | 463 | 463 | 413 | 413 |
| | 27,523 | 27,708 | 27,978 | 27,905 | 27,665 | 27,585 |
| Revenue mix %: | | | | | | |
| Medicare | 35 | 34 | 33 | 36 | 38 | 37 |
| Medicaid | 41 | 41 | 41 | 39 | 37 | 38 |
| Medicare Advantage | 6 | 7 | 7 | 7 | 7 | 7 |
| Private and other | 18 | 18 | 19 | 18 | 18 | 18 |
| Patient days (excludes managed facilities): | | | | | | |
| Medicare | 369,102 | 363,149 | 346,837 | 344,018 | 370,395 | 358,760 |
| Medicaid | 1,312,517 | 1,292,246 | 1,289,643 | 1,287,739 | 1,232,620 | 1,229,517 |
| Medicare Advantage | 87,692 | 92,051 | 91,643 | 94,336 | 97,460 | 94,483 |
| Private and other | 397,550 | 415,921 | 437,413 | 453,357 | 425,414 | 435,667 |
| | 2,166,861 | 2,163,367 | 2,165,536 | 2,179,450 | 2,125,889 | 2,118,427 |
| Patient day mix %: | | | | | | |
| Medicare | 17 | 17 | 16 | 16 | 17 | 17 |
| Medicaid | 61 | 60 | 60 | 59 | 58 | 58 |
| Medicare Advantage | 4 | 4 | 4 | 4 | 5 | 4 |
| Private and other | 18 | 19 | 20 | 21 | 20 | 21 |
| Revenues per patient day: | | | | | | |
| Medicare Part A | $ 470 | $ 469 | $ 468 | $ 534 | $ 537 | $ 544 |
| Total Medicare (including Part B) | 513 | 515 | 519 | 587 | 579 | 589 |
| Medicaid | 168 | 171 | 171 | 171 | 172 | 173 |
| Medicare Advantage | 398 | 400 | 405 | 432 | 416 | 420 |
| Private and other | 238 | 234 | 232 | 228 | 235 | 240 |
| Weighted average | 249 | 250 | 249 | 260 | 267 | 268 |
| Average daily census | 24,076 | 23,773 | 23,538 | 23,690 | 23,621 | 23,279 |
| Admissions (excludes managed facilities) | 19,026 | 18,924 | 19,383 | 19,118 | 20,619 | 20,143 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Occupancy % | 89.0 | 87.3 | 86.8 | 86.4 | 86.9 | 85.9 |
| Medicare average length of stay | 33.7 | 35.2 | 34.3 | 33.0 | 32.9 | 33.4 |
| Annualized employee turnover % | 36.7 | 38.8 | 39.8 | 39.6 | 37.8 | 39.8 |

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

**Operating Data (Continued)**

**(Unaudited)**

| | 2010 Quarters | | | | 2011 Quarters | |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second |
| **Rehabilitation data:** | | | | | | |
| Skilled nursing rehabilitation services: | | | | | | |
| Revenue mix %: | | | | | | |
| Company-operated | 57 | 56 | 55 | 49 | 47 | 34 |
| Non-affiliated | 43 | 44 | 45 | 51 | 53 | 66 |
| Sites of service (at end of period) | 554 | 568 | 595 | 635 | 641 | 1,848 |
| Revenue per site | $ 172,498 | $ 171,254 | $ 167,832 | $ 174,896 | $ 178,812 | $ 137,316 |
| Therapist productivity % | 83.8 | 84.2 | 82.1 | 78.6 | 80.6 | 81.6 |
| Home health and hospice revenues | $ 3,434 | $ 3,875 | $ 3,947 | $ 6,266 | $ 8,038 | $ 10,828 |
| Hospital rehabilitation services: | | | | | | |
| Revenue mix %: | | | | | | |
| Company-operated | 96 | 96 | 95 | 95 | 94 | 54 |
| Non-affiliated | 4 | 4 | 5 | 5 | 6 | 46 |
| Sites of service (at end of period): | | | | | | |
| Inpatient rehabilitation units | | | | 1 | 1 | 104 |
| LTAC hospitals | 85 | 85 | 85 | 91 | 93 | 97 |
| Subacute units | 7 | 7 | 7 | 7 | 8 | 22 |
| Outpatient units | 10 | 11 | 11 | 12 | 12 | 119 |
| Other | 2 | 2 | 4 | 4 | 5 | 8 |
| | 104 | 105 | 107 | 115 | 119 | 350 |
| Revenue per site | $ 203,337 | $ 199,174 | $ 190,986 | $ 184,193 | $ 188,989 | $ 199,661 |
| Annualized employee turnover % | 12.6 | 14.2 | 15.4 | 14.4 | 14.5 | 17.1 |

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## 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 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2014 | 2015 | Thereafter | Total | Fair value 6/30/11 |
| **Liabilities:** | | | | | | | | |
| Long-term debt, including amounts due within one year: | | | | | | | | |
| Fixed rate: | | | | | | | | |
| Notes | $ | $ | $ | $ | $ | $ 550,000 | $ 550,000 | $ 550,000 |
| Other | 47 | 96 | 102 | 109 | 116 | 133 | 603 | 580(a) |
| | $ 47 | $ 96 | $ 102 | $ 109 | $ 116 | $ 550,133 | $ 550,603 | $ 550,580 |
| Average interest rate | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | 8.2% | | |
| Variable rate: | | | | | | | | |
| ABL Facility (b) | $ | $ | $ | $ | $ | $ 190,000 | $ 190,000 | $ 190,000 |
| Term Loan Facility (c) | 3,500 | 7,000 | 7,000 | 7,000 | 7,000 | 668,500 | 700,000 | 697,375 |
| Other (d) | 116 | 232 | 233 | 233 | 3,720 | | 4,534 | 4,534 |
| | $ 3,616 | $ 7,232 | $ 7,233 | $ 7,233 | $ 10,720 | $ 858,500 | $ 894,534 | $ 891,909 |

(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 ABL Facility is payable, at the Company s option, at a rate per annum equal to the applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. The initial applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. Commencing with the completion of the Company s first fiscal quarter ending after the Merger, the applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

(c) Interest on borrowings under the Company s Term Loan Facility is payable, at the Company s option, at a rate per annum equal to an applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for

the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The initial applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings. The Term Loan Facility s expected maturities excludes the original issue discount of approximately $7 million.

(d) Interest based upon LIBOR plus 4%.

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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 June 30, 2011, 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.

Except as described below with respect to the status of the integration of RehabCare, there has been no change in the Company s internal control over financial reporting during the Company s quarter ended June 30, 2011, that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

On June 1, 2011, the Company completed the RehabCare acquisition. The Company is in the process of integrating RehabCare into the Company s existing internal control environment. The Company expects to exclude RehabCare from the assessment of internal control over financial reporting as of December 31, 2011.

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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.

On February 10, 2011, Arthur I. Murphy, Jr., a purported stockholder of RehabCare, filed a purported class action lawsuit in the Circuit Court of St. Louis County, Missouri (which we refer to as the Circuit Court ) against RehabCare, RehabCare s directors and Kindred (which we refer to as the Murphy litigation ); and on March 2, 2011, Alfred T. Kowalewski, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Circuit Court, Missouri against RehabCare, RehabCare s directors and Kindred (which we refer to as the Kowalewski litigation and, together with the Murphy litigation, the Missouri litigation ). On February 15, 2011, the Norfolk County Retirement System, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Court of Chancery against RehabCare, RehabCare s directors and Kindred (which we refer to as the Norfolk County litigation ); on February 28, 2011, City of Pontiac General Employees Retirement System, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Court of Chancery against RehabCare, RehabCare s directors and Kindred (which we refer to as the City of Pontiac litigation ); and on March 4, 2011, Plumbers & Pipefitters National Pension Fund, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Court of Chancery against RehabCare, RehabCare s directors and Kindred (which we refer to as the Plumbers & Pipefitters litigation and, together with the Norfolk County litigation and the City of Pontiac litigation, the Delaware litigation ).

The complaints in the Missouri litigation and Delaware litigation contain similar allegations, including among other things, that RehabCare s directors breached their fiduciary duties to the RehabCare stockholders, including their duties of loyalty, due care, independence, good faith and fair dealing, by entering into a merger agreement which provides for inadequate consideration to RehabCare stockholders, and that RehabCare and Kindred aided and abetted RehabCare s directors alleged breaches of their fiduciary duties. The plaintiffs seek injunctive relief preventing the defendants from consummating the transactions contemplated by the merger agreement, or in the event the defendants consummate the transactions contemplated by the merger agreement, rescission of such transactions and attorneys fees and expenses.

On March 8, 2011, the plaintiffs in the Kowalewski litigation filed a motion with the Circuit Court to consolidate the Missouri litigation and to appoint lead counsel. On March 31, 2011, the plaintiffs in the Kowalewski litigation filed an amended complaint and a motion for expedited discovery and on April 11, 2011, the plaintiffs in the Murphy litigation filed an amended complaint and a motion for expedited discovery. This April 11, 2011 amended complaint in the Murphy litigation also added Citigroup Global Markets Inc. as a named defendant in the litigation. On April 7, 2011, the defendants filed a motion to dismiss and/or stay the Missouri litigation. After holding hearings on April 8 and April 22, 2011, the Circuit Court stayed the Missouri litigation by Order dated April 25, 2011.

On March 9, 2011, the Court of Chancery consolidated the Delaware litigation under the caption *In Re RehabCare Group, Inc. Shareholders Litigation* and plaintiffs filed a verified consolidated class action complaint on April 5, 2011. Defendants commenced document production on March 30, 2011 and substantially completed it by April 22, 2011. Depositions took place between April 28, 2011 and May 11, 2011.

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**PART II. OTHER INFORMATION (Continued)**

**Item 1. Legal Proceedings (Continued)**

On May 12, 2011, the defendants entered into a memorandum of understanding with the plaintiffs in the Delaware litigation regarding the settlement of the Delaware litigation. In connection with the settlement contemplated by the memorandum of understanding, (i) Kindred and RehabCare agreed to make certain additional disclosures related to the proposed merger, which were contained in a Form 8-K filed with the SEC on May 12, 2011, (ii) RehabCare agreed to make the payment, at and subject to the closing of the merger between Kindred and RehabCare, of $2.5 million in cash into a settlement pool for the benefit of the plaintiff class in *In re RehabCare Group, Inc. Shareholders Litigation*, to be distributed after final approval of the settlement of the Delaware Litigation and (iii) Kindred, Kindred Healthcare Development, Inc. and RehabCare agreed to enter into an amendment, dated May 12, 2011, to the merger agreement, dated as of February 7, 2011, among Kindred, Kindred Healthcare Development, Inc. and RehabCare, the material terms of which are as follows:

- inclusion of an acknowledgement by Kindred and RehabCare of the waiver of any existing standstill undertakings for the benefit of RehabCare;
- change of the definition of Company Termination Fee to mean an amount equal to $13 million; and
- modification of the agreement to eliminate the requirement for a three-business day period during which Kindred has the right to match a superior proposal.

A copy of the Amendment to Agreement and Plan of Merger was filed as Exhibit 2.1 to the Form 8-K filed with the SEC on May 12, 2011. The foregoing description of such Amendment to Agreement and Plan of Merger is qualified by this exhibit which is incorporated herein by reference.

On June 29, 2011, the parties submitted to the Court of Chancery a proposed Stipulation of Settlement and Dismissal, which the Court granted on July 1, 2011. Additionally, the Court set a formal settlement hearing for Thursday, September 8, 2011. The purpose of the hearing is for the Court to resolve all remaining issues surrounding the settlement including the application by the plaintiffs counsel for the award of reasonable attorneys fees and expenses for prosecuting this action.

**Item 1A. Risk Factors**

The following risk factors update the risk factors included in the Company s Form 10-K for the year ended December 31, 2010 and should be read in conjunction therewith.

***Final rules issued by CMS providing for reductions in Medicare reimbursement to nursing centers and changes in payments for the provision of group rehabilitation therapy services, are expected to adversely affect the Company s revenues, and other potential reimbursement changes resulting from the Budget Control Act of 2011 could further adversely affect the Company s business, financial condition, results of operations or liquidity.***

CMS issued a final rule on July 29, 2011 updating Medicare payment rates for skilled nursing centers effective October 1, 2011. The final rule imposes (1) a negative adjustment to RUGs IV therapy rates, and (2) a net market basket increase of 1.7% consisting of (a) a 2.7% market basket inflation increase, less (b) a 1.0% adjustment to account for the effect of a productivity adjustment, beginning on October 1, 2011. CMS has projected the impact of these changes will result in an 11.1% decrease in payments to skilled nursing centers. Under the final rule, group therapy would be defined as therapy sessions with four patients who are performing similar therapy activities. In addition, for purposes of assigning patients to RUGs IV payment categories, the minutes of group therapy would be allocated based upon the number of patients in the therapy session, consistent with the rules for concurrent therapy that have been in place since October 1, 2010. The final rule also clarifies circumstances

for reporting breaks of three or more days of therapy and implements a new change of therapy assessment to capture those changes in a patient s therapy status that would be sufficient to affect the RUGs IV classification and payment. Management believes that these rules could reduce the Company s annual revenues

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**PART II. OTHER INFORMATION (Continued)**

**Item 1A. Risk Factors (Continued)**

by approximately $85 million to $95 million in its nursing center business and approximately $10 million to $15 million in its rehabilitation therapy business. In addition, management believes that other technical changes required under the final rules may increase rehabilitation therapy costs by approximately $10 million to $15 million on an annual basis.

The Budget Control Act of 2011, enacted on August 2, 2011, increased the United States debt ceiling in connection with deficit reductions over the next ten years. The Budget Control Act of 2011 also establishes a twelve-member joint committee of Congress known as the Joint Select Committee on Deficit Reduction. The goal of the Joint Select Committee on Deficit Reduction is to propose legislation to reduce the United States federal deficit by $1.5 trillion for fiscal years 2012-2021. Reductions in Medicare and Medicaid spending could be included as part of these deficit reduction measures. Moreover, if such legislation is not enacted by December 23, 2011, approximately $1.2 trillion in domestic and defense spending reductions will automatically begin January 1, 2013, split evenly between domestic and defense spending. Payments to Medicare providers would be subject to these automatic spending reductions, subject to a 2% cap. At this time it is unclear how this automatic reduction may be applied to various Medicare healthcare programs. Reductions to Medicare and Medicaid reimbursement from the Budget Control Act of 2011 could have a material adverse effect on the Company s business, financial position, results of operations or liquidity.

**Item 6. Exhibits**

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| 2.1 | Amendment to Agreement and Plan of Merger, dated May 12, 2011, among Kindred Healthcare, Inc., Kindred Healthcare Development, Inc. and RehabCare Group, Inc. Exhibit 2.1 to the Company s Current Report on Form 8-K dated May 12, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 2.2 | Certificate of Ownership and Merger merging Kindred Escrow Corp. into Kindred Healthcare, Inc. Exhibit 3.1 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 4.1 | Indenture (including form of Note), dated as of June 1, 2011, between Kindred Escrow Corp. and Wells Fargo Bank, National Association, as trustee. Exhibit 4.1 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 4.2 | Supplemental Indenture, dated as of June 1, 2011, among Kindred Healthcare, Inc., the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as trustee. Exhibit 4.2 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 4.3 | Registration Rights Agreement, dated as of June 1, 2011, between Kindred Escrow Corp. and J.P. Morgan Securities LLC. Exhibit 4.3 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 4.4 | Joinder Agreement to Registration Rights Agreement, dated as of June 1, 2011, among Kindred Healthcare, Inc. and the Subsidiary Guarantors party thereto. Exhibit 4.4 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 10.1 | ABL Credit Agreement, dated as of June 1, 2011, among Kindred Healthcare, Inc., the Lenders party thereto, JPMorgan Chase Bank, N.A. as Administrative Agent and Collateral Agent and the arrangers and agents party thereto. Exhibit 10.1 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |

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**PART II. OTHER INFORMATION (Continued)**

**Item 6. Exhibits (Continued)**

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|---|---|
| 10.2 | Term Loan Credit Agreement, dated as of June 1, 2011, among Kindred Healthcare, Inc., the Lenders party thereto, JPMorgan Chase Bank, N.A. as Administrative Agent and Collateral Agent and the arrangers and other agents party thereto. Exhibit 10.2 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 10.3 | Kindred Healthcare, Inc. 2011 Stock Incentive Plan. Annex F to the Company s Registration Statement on Form S-4 filed with the Securities and Exchange Commission on April 20, 2011 (Comm. File No. 333-173050) is hereby incorporated by reference. |
| 10.4 | Form of Kindred Healthcare, Inc. Non-Qualified Stock Option Grant Agreement under the 2011 Stock Incentive Plan. |
| 10.5 | Form of Kindred Healthcare, Inc. Incentive Stock Option Grant Agreement under the 2011 Stock Incentive Plan. |
| 10.6 | Form of Kindred Healthcare, Inc. Restricted Share Award Agreement under the 2011 Stock Incentive Plan. |
| 10.7 | Form of Kindred Healthcare, Inc. Stock Bonus Award Agreement under the 2011 Stock Incentive Plan. |
| 10.8 | Form of Kindred Healthcare, Inc. Performance Unit Award Agreement under the 2011 Stock Incentive Plan. |
| 31 | Rule 13a-14(a)/15d-14(a) Certifications. |
| 32 | Section 1350 Certifications. |
| 101.XML | XBRL Instance Document. * |
| 101.XSD | XBRL Taxonomy Extension Schema Document. * |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. * |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document.* |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document. * |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. * |

* In accordance with Regulation S-T, the XBRL-related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall be deemed to be furnished and not filed.

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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: August 9, 2011

/s/ PAUL J. DIAZ
**Paul J. Diaz**
**President and**

**Chief Executive Officer**

Date: August 9, 2011

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

**Chief Financial Officer**