HEALTHSOUTH CORP
Form 10-Q
August 14, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2006

Commission File Number 000-14940

HealthSouth Corporation

(Exact name of Registrant as specified in its Charter)

Delaware	**63-0860407**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
One HealthSouth Parkway	
Birmingham, Alabama	**35243**
(Address of Principal Executive Offices)	**(Zip Code)**

(205) 967-7116

(Registrant s telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ¨ No x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large accelerated filer x Accelerated filer ¨ Non-Accelerated filer ¨

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

The registrant had 398,070,542 shares of common stock outstanding, net of treasury shares, as of July 31, 2006.

PRELIMINARY NOTE

On August 14, 2006, we announced that we will explore a range of strategic alternatives to enhance stockholder value and to reposition our primary focus on the post-acute care sector. These strategic alternatives include, but are not limited to, the spin-off, sale or other disposition of our surgery centers and outpatient rehabilitation divisions, together with our previously announced determination with respect to our diagnostic division.

We have engaged Goldman Sachs & Co. to assist us in this process which is expected to take approximately 12 months to complete. We caution there can be no assurance that the exploration of strategic alternatives will result in any agreements or transactions.

The determination to explore strategic alternatives is based on a number of factors, including:

- our existing divisions compete in sectors with substantial growth potential;
- our significant debt burden, coupled with settlement obligations paid and to be paid with respect to settlements with the Securities and Exchange Commission and the Department of Justice, Civil Division, limit our ability to pursue such growth opportunities;
- we have concluded there are very few strategic or financial synergies in operating our existing divisions as one company and, in some instances, the strategic interests of these divisions are at cross purposes with one another;
- we believe that a pure play post-acute strategy builds on our core competencies in the area of inpatient rehabilitative care and is responsive to industry trends; and
- the proceeds of any sale of the surgery centers, outpatient rehabilitation and diagnostic divisions would be used to deleverage the company, thereby allowing us to pursue growth opportunities in our inpatient rehabilitation division and complementary post-acute businesses under the HealthSouth name.

On August 14, 2006, we also announced that we have been cleared to submit an application for the listing of our common stock on the New York Stock Exchange, Inc. (NYSE) and we anticipate that we will begin trading on the NYSE by the end of October under the ticker symbol HLS . In connection with this relisting, we will seek stockholder approval for a one-for-five reverse stock split to bring the share price of our common stock, along with the number of shares of our common stock outstanding, to a range more in line with other health care companies with comparable market capitalization. We will soon file a preliminary proxy statement with the Securities and Exchange Commission with respect to the stockholders meeting to approve such reverse stock split and anticipate completing the reverse stock split prior to the time our common stock begins trading on the NYSE by the end of October.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

HealthSouth Corporation and Subsidiaries

Condensed Consolidated Balance Sheets

(Unaudited)

	June 30, 2006	December 31, 2005
	(In Thousands, Except Share Data)	
Assets		
Current assets:		
Cash and cash equivalents	$ 53,856	$ 175,617
Current portion of restricted cash	161,643	156,412
Marketable securities		23,839
Accounts receivable, net of allowance for doubtful accounts of $130,122 in 2006; $124,060 in 2005	404,699	403,887
Other current assets	103,661	114,500
Total current assets	723,859	874,255
Property and equipment, net	1,153,879	1,197,944
Goodwill	913,820	911,403
Intangible assets, net	50,408	54,247
Investment in and advances to nonconsolidated affiliates	55,721	46,388
Other long-term assets	412,862	507,976
Total assets	$ 3,310,549	$ 3,592,213
Liabilities and Shareholders Deficit		
Current liabilities:		
Current portion of long-term debt	$ 60,164	$ 33,866
Accounts payable	100,206	123,899
Accrued expenses and other current liabilities	394,318	476,616
Refunds due patients and other third-party payors	122,008	142,319
Current portion of government, class action, and related settlements	361,020	333,124
Total current liabilities	1,037,716	1,109,824
Long-term debt, net of current portion	3,273,843	3,368,071
Government, class action, and related settlements, net of current portion	68,449	135,245
Other long-term liabilities	270,018	246,052
	4,650,026	4,859,192
Commitments and contingencies		
Minority interest in equity of consolidated affiliates	292,909	273,742
Convertible perpetual preferred stock, $.10 par value; 1,500,000 shares authorized; issued: 400,000 in 2006; none issued and outstanding in 2005; liquidation preference of $1,000 per share	387,403	
Shareholders deficit:		
	4,410	4,405

Common stock, $.01 par value; 600,000,000 shares authorized; issued: 440,991,021 in 2006; 440,504,976 in 2005		
Capital in excess of par value	2,850,914	2,851,993
Accumulated deficit	(4,566,401)	(4,088,827)
Accumulated other comprehensive loss	(1,294)	(937)
Treasury stock, at cost (42,835,989 shares in 2006 and 42,796,508 in 2005)	(307,302)	(307,120)
Notes receivable from shareholders, officers, and management employees	(116)	(235)
Total shareholders deficit	(2,019,789)	(1,540,721)
Total liabilities and shareholders deficit	$ 3,310,549	$ 3,592,213

The accompanying notes to condensed consolidated financial

statements are an integral part of these condensed balance sheets.

HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Operations and Comprehensive Loss

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(In Thousands, Except Per Share Data)			
Net operating revenues	$ 787,513	$ 818,277	$ 1,577,326	$ 1,663,172
Operating expenses:				
Salaries and benefits	354,870	360,371	717,596	725,445
Professional and medical director fees	19,978	23,073	41,327	39,464
Supplies	73,631	79,485	148,847	157,212
Other operating expenses	168,442	194,292	322,166	341,118
Provision for doubtful accounts	29,592	22,836	52,585	46,321
Depreciation and amortization	38,917	40,199	75,851	89,038
Loss (gain) on disposal of assets	2,954	(2,247)	(2,105)	12,305
Impairment of intangible assets	108		108	
Impairment of long-lived assets	3,752	12,978	3,752	24,915
Government, class action, and related settlements expense	17,186		17,313	215,000
Professional fees accounting, tax, and legal	27,996	28,981	76,632	80,370
Total operating expenses	737,426	759,968	1,454,072	1,731,188
Loss on early extinguishment of debt	4,565	33	365,642	33
Interest expense and amortization of debt discounts and fees	82,974	84,433	168,228	170,851
Interest income	(4,317)	(3,516)	(8,377)	(6,894)
(Gain) loss on sale of investments	(1,049)	4,592	(1,943)	2,941
Gain on interest rate swap	(18,604)		(14,789)	
Equity in net income of nonconsolidated affiliates	(5,618)	(5,875)	(10,163)	(16,820)
Minority interests in earnings of consolidated affiliates	21,077	24,566	57,217	57,057
Loss from continuing operations before income tax expense	(28,941)	(45,924)	(432,561)	(275,184)
Provision for income tax expense	9,086	9,540	27,019	20,418
Loss from continuing operations	(38,027)	(55,464)	(459,580)	(295,602)
Loss from discontinued operations, net of income tax expense	(4,409)	(6,949)	(17,994)	(25,015)
Net loss	$ (42,436)	$ (62,413)	$ (477,574)	$ (320,617)
Convertible perpetual preferred dividends	(9,244)		(9,244)	
Net loss available to common shareholders	$ (51,680)	$ (62,413)	$ (486,818)	$ (320,617)
Comprehensive loss:				
Net loss	$ (42,436)	$ (62,413)	$ (477,574)	$ (320,617)
Other comprehensive loss, net of tax:				
Foreign currency translation adjustment	288	(203)	(123)	(314)
Unrealized gain on available-for-sale securities	(293)	(26)	(234)	
Other comprehensive loss	(5)	(229)	(357)	(314)
Comprehensive loss	$ (42,441)	$ (62,642)	$ (477,931)	$ (320,931)

Weighted average common shares outstanding:								
Basic		398,165		397,047		397,725		396,529
Diluted		464,511		398,827		439,411		398,693
Basic and diluted loss per share:								
Loss from continuing operations available to common shareholders	$	(0.12)	$	(0.14)	$	(1.18)	$	(0.75)
Loss from discontinued operations, net of tax		(0.01)		(0.02)		(0.04)		(0.06)
Net loss per share available to common shareholders	$	(0.13)	$	(0.16)	$	(1.22)	$	(0.81)

The accompanying notes to condensed consolidated financial

statements are an integral part of these condensed statements.

HealthSouth Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

	Six Months Ended June 30, 2006	2005
	(In Thousands)	
Net cash used in operating activities	$ (50,564)	$ (20,361)
Cash flows from investing activities:		
Capital expenditures	(43,213)	(52,379)
Proceeds from disposal of assets	7,879	4,631
Proceeds from sale and maturities of marketable securities	32,309	41
Purchase of investments, net of cash equivalents	(67,408)	(547)
Proceeds from sale of equity interests of nonconsolidated affiliates	2,998	
Repurchase of equity interests of nonconsolidated affiliates	(32)	(57)
Proceeds from sale of equity interests of consolidated affiliates	14,912	10,522
Repurchase of equity interests of consolidated affiliates	(5,074)	(8,453)
Decrease in cash related to conversion of consolidated affiliates to equity method affiliates	(691)	(3,832)
(Decrease) increase in cash related to conversion of equity method affiliates to consolidated affiliates	(103)	2,089
Net cash settlement on interest rate swap	(1,815)	
Net change in restricted cash	66,267	21,309
Net cash provided by investing activities of discontinued operations	27,558	1,951
Net cash provided by (used in) investing activities	33,587	(24,725)
Cash flows from financing activities:		
Checks in excess of bank balance	(29,975)	(10,598)
Principal borrowings on notes	3,050,000	200,065
Proceeds from bond issuance	1,000,000	
Principal payments on debt	(4,426,689)	(249,086)
Borrowings on revolving credit facility	50,000	
Principal payments under capital lease obligations	(9,630)	(15,716)
Issuance of convertible perpetual preferred stock	400,000	
Preferred stock issuance costs	(12,597)	
Debt issuance costs	(77,687)	(17,852)
Distributions to minority interests of consolidated affiliates	(40,592)	(37,318)
Proceeds from repayment of notes receivable from shareholders, officers, and management employees	119	
Net cash used in financing activities of discontinued operations	(8,524)	(1,468)
Net cash used in financing activities	(105,575)	(131,973)
Effect of exchange rate on cash and cash equivalents	(123)	(314)
Decrease in cash and cash equivalents	(122,675)	(177,373)
Cash and cash equivalents at beginning of period	175,617	449,097
Cash and cash equivalents of discontinued operations at beginning of period	1,977	6,314
Less: Cash and cash equivalents of discontinued operations at end of period	(1,063)	(5,152)
Cash and cash equivalents at end of period	$ 53,856	$ 272,886

The accompanying notes to condensed consolidated financial

statements are an integral part of these condensed statements.

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HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation:

HealthSouth Corporation, incorporated in Delaware in 1984, including its subsidiaries, is one of the largest providers of rehabilitative health care, ambulatory surgery, and diagnostic imaging services in the United States. References herein to HealthSouth, the Company, we, our, or u refer to HealthSouth Corporation and its subsidiaries unless otherwise stated or indicated by context. We provide these services through a national network of inpatient and outpatient rehabilitation facilities, outpatient surgery centers, diagnostic centers, and other health care facilities.

The accompanying unaudited condensed consolidated financial statements of HealthSouth Corporation and Subsidiaries should be read in conjunction with the consolidated financial statements and accompanying notes filed with the U.S. Securities and Exchange Commission (the SEC) in HealthSouth s 2005 Annual Report on Form 10-K (the 2005 Form 10-K). The unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the SEC applicable to interim financial information. Certain information and note disclosures included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) have been omitted in these interim statements, as allowed by such SEC rules and regulations. The condensed consolidated balance sheet as of December 31, 2005 has been derived from audited financial statements, but it does not include all disclosures required by GAAP. However, we believe the disclosures are adequate to make the information presented not misleading.

The unaudited results of operations for the interim periods shown in these financial statements are not necessarily indicative of operating results for the entire year. In our opinion, the accompanying condensed consolidated financial statements recognize all adjustments of a normal recurring nature considered necessary to fairly state the financial position, results of operations, and cash flows for each interim period presented.

Reclassifications

Certain financial results have been reclassified to conform to the current period presentation. Such reclassifications primarily relate to facilities we closed or sold in the three months ended June 30, 2006 that qualify under Financial Accounting Standards Board (FASB) Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to be reported as discontinued operations. We reclassified our condensed consolidated balance sheet for the year ended December 31, 2005, presented our condensed consolidated statements of operations and comprehensive loss for the three and six months ended June 30, 2005, and presented our condensed consolidated statement of cash flows for the six months ended June 30, 2005 to show the results of those qualifying facilities in the three months ended June 30, 2006 as discontinued operations.

Marketable Securities

As disclosed in Note 1, *Summary of Significant Accounting Policies*, Marketable Securities, to our 2005 Form 10-K, we record all investments in debt and equity securities with readily determinable fair values and for which we do not exercise significant influence as available-for-sale securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

As of June 30, 2006, we had approximately $51.5 million of restricted marketable securities included in *Other long-term assets* in our condensed consolidated balance sheet. These marketable securities represent restricted assets held at our wholly owned insurance captive, HCS, Ltd., in the Cayman Islands. HCS handles professional liability, workers compensation, and other insurance claims on behalf of HealthSouth. These funds are committed for payment of claims incurred. As of December 31, 2005, these funds were part of the restricted cash disclosed in Note 1, *Summary of Significant Accounting Policies*, Restricted Cash, of our 2005 Form 10-K.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Convertible Perpetual Preferred Stock

We classify our *Convertible perpetual preferred stock* on the balance sheet using the guidance in SEC Accounting Series Release No. 268, *Presentation in Financial Statements of Redeemable Preferred Stocks,* and Emerging Issues Task Force (EITF) Topic D-98, Classification and Measurement of Redeemable Securities. Our *Convertible perpetual preferred stock* contains fundamental change provisions that allow the holder to require us to redeem the preferred stock for cash if certain events occur. As redemption under these provisions is not solely within our control, we have classified our *Convertible perpetual preferred stock* as temporary equity.

We also examined whether the embedded conversion option in our *Convertible perpetual preferred stock* should be bifurcated under the guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock, and we determined that bifurcation is not necessary.

Stock-Based Compensation

HealthSouth has various shareholder- and non-shareholder-approved stock-based compensation plans that provide for the granting of stock-based compensation to certain employees and directors, which are described more fully in Note 6, *Stock-Based Compensation*, and in our 2005 Form 10-K. Prior to January 1, 2006, we accounted for those stock-based compensation plans using the recognition and measurement principles of the intrinsic value method of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and its related interpretations, and applied the disclosure-only provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Under the intrinsic value method, we recognized compensation expense on the date of grant only if the current market price of the underlying stock on the grant date exceeded the exercise price of the stock-based award.

In December 2004, the FASB issued FASB Statement No. 123 (Revised 2004), *Share-Based Payment*, which revises FASB Statement No. 123 and supersedes APB Opinion No. 25. FASB Statement No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005. Subsequent to the effective date, the pro forma disclosures previously permitted under FASB Statement No. 123 are no longer an alternative to financial statement recognition.

In March 2005, the Staff of the SEC issued Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*. SAB No. 107 expresses the view of the SEC Staff regarding the interaction between FASB Statement No. 123(R) and certain SEC rules and regulations and provides the SEC Staff s views regarding the valuation of share-based payment arrangements for public companies. The SEC Staff believes the guidance in SAB No. 107 will assist public companies in their initial implementation of FASB Statement No. 123(R) beginning with the first interim or annual period of the first fiscal year that begins after June 15, 2005.

Effective January 1, 2006, we adopted FASB Statement No. 123(R) using the modified prospective method. Under this method, compensation cost recognized during 2006 includes: (1) compensation cost for the portions of all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FASB Statement No. 123 amortized on a straight-line basis over the options remaining vesting period beginning January 1, 2006, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of FASB Statement No. 123(R) amortized on a straight-line basis over the options requisite service period. Pro forma results for prior periods have not been restated. We calculated the historical pool of windfall tax benefits using the short cut method allowed under FASB Staff Position No. FAS 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As a result of adopting FASB Statement No. 123(R) on January 1, 2006, our *Loss from continuing operations before income tax expense* and our *Net loss* are $3.1 million and $5.8 million higher for the three and six months ended June 30, 2006, respectively, than had we continued to account for stock-based compensation under APB Opinion No. 25. The impact on basic and diluted *Net loss per share available to common shareholders* of adopting FASB Statement No. 123(R) was an increase in *Net loss per share available to common shareholders* for both the three and six months ended June 30, 2006 of $0.01 per common share. The adoption of FASB Statement No. 123(R) had no impact on cash flows from operations or financing activities. There were no material recognized tax benefits during the three months ended June 30, 2006 or the six months ended June 30, 2006 related to our adoption of FASB Statement No. 123(R).

The following table illustrates the effect on *Net loss available to common shareholders* and *Net loss per share available to common shareholders* had we applied the fair value recognition provisions of FASB Statement No. 123 to account for our stock-based compensation during the three and six months ended June 30, 2005, since stock-based compensation was not accounted for using the fair value recognition method during those periods. For purposes of pro forma disclosure, the estimated fair value of the stock awards, as prescribed by FASB Statement No. 123, is amortized to expense over the vesting period of such awards (in thousands, except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss available to common shareholders, as reported	$ (62,413)	$ (320,617)
Add: Stock-based employee compensation expense included in reported net loss	618	868
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(3,403)	(4,708)
Pro forma net loss available to common shareholders	$ (65,198)	$ (324,457)
Net loss per share available to common shareholders:		
Basic and diluted as reported	$ (0.16)	$ (0.81)
Basic and diluted pro forma	$ (0.16)	$ (0.82)

The historical pro forma impact of applying the fair value method prescribed by FASB Statement No. 123 is not representative of the impact that may be expected in the future due to changes in option grants in future years and changes in assumptions such as volatility, interest rates, and expected life used to estimate the fair value of future grants.

Derivative Instruments

We account for derivative instruments under the guidance in FASB Statement No. 133 and its related amendments in FASB Statement No. 137, *Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities an Amendment of FASB Statement No.133*, and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. FASB Statement No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or in other comprehensive income, depending on whether a derivative is designated as part of a hedging relationship and, if it is, depending on the type of hedging relationship.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As of June 30, 2006, we hold only one derivative instrument, an interest rate swap, that is not designated as a hedge. Therefore, in accordance with FASB Statement No. 133, all changes in the fair value of this interest rate swap are reported in current-period earnings. For additional information regarding this interest rate swap, see Note 4, *Long-term Debt*.

Professional Fees Accounting, Tax, and Legal

Professional fees accounting, tax, and legal for the three months ended June 30, 2006 related primarily to professional services to support the preparation of our Form 10-Q for the first quarter of 2006 (including the preparation of quarterly information for 2005, which had never been presented), tax preparation and consulting fees related to various tax projects, and legal fees for continued litigation defense and support for matters discussed in Note 11, *Contingencies*. During the six months ended June 30, 2006, these fees primarily related to professional services used to support the preparation of our 2005 Form 10-K, as well as those discussed above. During the three months ended June 30, 2005 and the six months ended June 30, 2005, these fees primarily related to the preparation of our comprehensive Form 10-K for the years ended December 31, 2003 and 2002, including the restatement of our previously issued 2001 and 2000 consolidated financial statements.

Recent Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. FASB Interpretation No. 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FASB Statement No. 109 does not prescribe a recognition threshold or measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. FASB Interpretation No. 48 clarifies the application of FASB Statement No. 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in a company s financial statements. Additionally, FASB Interpretation No. 48 provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

FASB Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Early adoption is permitted as of the beginning of a company s fiscal year, provided the company has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. As we do not meet the requirements for early adoption, we will adopt FASB Interpretation No. 48 on January 1, 2007. The cumulative effects, if any, of applying this Interpretation will be recorded as an adjustment to *Accumulated deficit* as of January 1, 2007. We are currently evaluating the potential impact of FASB Interpretation No. 48 on our financial position, results of operations, and cash flows.

Since the filing of our 2005 Form 10-K, we do not believe any other recently issued, but not yet effective, accounting standards will have a material effect on our consolidated financial position, results of operations, or cash flows.

2. Guarantees:

In conjunction with the sale of certain facilities in prior years, HealthSouth agreed to enter into subleases for certain properties with certain purchasers and, as a condition of the sublease, agreed to act as a guarantor of the purchaser s performance on the sublease. Should the purchaser, as sublessee, fail to pay the rent due on these leases, the lessor would have contractual recourse against us.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As of June 30, 2006, we had entered into five such sublease guarantee arrangements. The remaining terms of these subleases range from six months to eight years. If we were required to perform under all such guarantees, the maximum amount we would be required to pay approximates $12.6 million.

We have not recorded a liability for these guarantees, as we do not believe it is probable we will have to perform under these agreements. If we are required to perform under these guarantees, we could potentially have recourse against the sublessee for recovery of any amounts paid. These guarantees are not secured by any assets under the leases. As of June 30, 2006, we have not been required to perform under any such sublease guarantees.

3. Investment in and Advances to Nonconsolidated Affiliates:

The following summarizes the combined results of operations of our equity method affiliates (on a 100% basis, in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net operating revenues	$ 39,700	$ 41,474	$ 74,939	$ 76,934
Operating expenses	(28,153)	(27,923)	(52,934)	(50,545)
Income from continuing operations	11,547	13,551	22,005	26,389
Net income	$ 9,873	$ 13,418	$ 19,496	$ 25,082

Source Medical

In April 2001, we established Source Medical Solutions, Inc. (Source Medical) to continue development and allow commercial marketing of a wireless clinical documentation system originally developed by HealthSouth. This proprietary software was referred to internally as HCAP and was later marketed by Source Medical under the name TherapySource. At the time of our initial investment, certain of our directors, executive officers, and employees also purchased shares of Source Medical s common stock.

From 2000 through 2003, Source Medical was dependent on HealthSouth for the majority of its revenues and funding. We advanced approximately $125 million to Source Medical between 2001 and 2003 to continue to develop HCAP and to fund other operations and acquisitions. The majority of our loans and advances to Source Medical have been excused in debt restructuring agreements to facilitate recapitalization efforts. Our new ownership has been diluted to less than 7% as part of these recapitalizations and to accommodate new investment from unrelated parties. Through December 2005, we held two of five seats on Source Medical s board of directors. In December 2005, we gave up these seats but retained certain observation rights into Source Medical s operations.

During 2002, Source Medical borrowed $5.0 million for working capital from an unrelated third-party financial institution. HealthSouth guaranteed the loan. In March 2003, the loan was called, and we were required to pay $5.1 million to repay the loan, including interest, on behalf of Source Medical. In our 2002 consolidated financial statements, we accrued $5.1 million as an uncollectible amount due from Source Medical. In the fourth quarter of 2005, we received a $5.0 million payment from Source Medical related to this note.

Additionally, during 2001, HealthSouth guaranteed a $6.0 million promissory note executed by Source Medical as part of an acquisition of a company. Source Medical did not perform under the terms of the promissory note and litigation ensued. Therefore, we recorded a $6.0 million liability due to our guarantee of the promissory note. In December 2005, Source Medical reached a settlement agreement related to the litigation, and

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

a dismissal of these matters occurred in U.S. District Court on March 30, 2006. Therefore, the $6.0 million liability was reversed as a reduction of *Other operating expenses* in March 2006.

We received approximately $1.0 million in interest payments throughout 2005 related to notes outstanding with Source Medical. From May 2003 to December 2004, Source Medical did not make interest payments on any notes due to us. In May 2006, we received a payment of $6.9 million in full satisfaction of all the then outstanding notes receivable and accrued interest due from Source Medical. This payment was included as a reduction of *Other operating expenses* in our condensed consolidated statements of operations and comprehensive loss for the three and six months ended June 30, 2006.

We continue to lease HCAP software from Source Medical and we remain a major customer of Source Medical.

4. Long-term Debt:

Our long-term financing obligations outstanding consist of the following (in thousands):

	June 30, 2006	**December 31, 2005**
Advances under $250 million revolving credit facility	$	$
Advances under $400 million revolving credit facility	50,000	
Senior Term Loans		313,425
Term Loans		200,000
Term Loan Facility	2,050,000	
Interim Loan		
Bonds Payable		
7.000% Senior Notes due 2008	4,967	249,162
10.750% Senior Subordinated Notes due 2008	30,220	318,312
8.500% Senior Notes due 2008	9,429	343,000
8.375% Senior Notes due 2011	310	347,365
7.375% Senior Notes due 2006	16,618	180,300
7.625% Senior Notes due 2012	1,520	904,839
6.500% Convertible Subordinated Debentures due 2011		6,311
8.750% Convertible Subordinated Notes due 2015		10,136
10.375% Senior Subordinated Credit Agreement due 2011		332,356
Floating Rate Senior Notes	375,000	
10.75% Senior Notes due 2016	615,677	
Hospital revenue bond		500
Notes payable to banks and others at interest rates from 6.0% to 12.9%	5,565	6,155
Noncompete agreements	91	154
Capital lease obligations	174,610	189,922
	3,334,007	3,401,937
Less current portion	(60,164)	(33,866)
Long-term debt, less current portion	$ 3,273,843	$ 3,368,071

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The following chart shows scheduled payments due on long-term debt for the next five years and thereafter (in thousands):

	Face Amount	Net Amount
July 1 through December 31, 2006	$ 36,179	$ 35,894
2007	44,549	43,947
2008	80,456	79,792
2009	41,734	41,024
2010	42,154	41,359
2011	36,753	35,862
Thereafter	3,061,594	3,056,129
Total	$ 3,343,419	$ 3,334,007

The following table provides information regarding our *Interest expense and amortization of debt discounts and fees* presented in our condensed consolidated statements of operations and comprehensive loss (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Interest expense	$ 77,384	$ 74,189	$ 153,883	$ 148,784
Amortization of debt discounts	32	1,391	1,101	2,900
Amortization of consent fees/bond issue costs	237	7,976	5,213	15,294
Amortization of loan fees	5,321	877	8,031	3,873
Total	$ 82,974	$ 84,433	$ 168,228	$ 170,851

The discussion that follows highlights the recapitalization transactions that occurred during the three months ended March 31, 2006 and the private offering of $1.0 billion of senior notes that occurred in June 2006. For a description of all other indebtedness, as well as a more detailed description of each of the recapitalization transactions, see our 2005 Form 10-K and Note 5, *Convertible Perpetual Preferred Stock*. The terms Amended and Restated Credit Agreement and Term Loan Agreement are defined in Note 8, *Long-term Debt*, to the consolidated financial statements accompanying our 2005 Form 10-K.

Recapitalization Transactions

On March 10, 2006, we completed the last of a series of recapitalization transactions (the Recapitalization Transactions) enabling us to prepay substantially all of our prior indebtedness and replace it with approximately $3 billion of new long-term debt. The Recapitalization Transactions included (1) entering into credit facilities that provide for credit of up to $2.55 billion of senior secured financing, (2) entering into an interim loan agreement that provides us with $1.0 billion of senior unsecured financing, (3) completing a $400 million offering of convertible perpetual preferred stock, (4) completing cash tender offers to purchase substantially all $2.03 billion of our previously outstanding senior notes and $319 million of our previously outstanding senior subordinated notes and consent solicitations with respect to proposed amendments to the indentures governing each outstanding series of notes, and (5) prepaying and terminating our 10.375% Senior Subordinated Credit Agreement, our Amended and Restated Credit Agreement, and our Term Loan Agreement. In order to complete the Recapitalization Transactions, we also entered into consents, amendments, and waivers to our Amended and Restated Credit Agreement, $200 million Term Loan Agreement, and $355 million 10.375% Senior Subordinated Credit Agreement.

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We used a portion of the proceeds of the loans under the new senior secured credit facilities, the proceeds of the interim loan, and the proceeds of the $400 million offering of convertible perpetual preferred stock, along with cash on hand and cash obtained from liquidation of available-for-sale marketable securities, to prepay substantially all of our prior indebtedness and to pay fees and expenses related to such prepayment and the Recapitalization Transactions. The remainder of the proceeds and availability under the senior secured credit facilities are expected to be used for general corporate purposes. In addition, the letters of credit issued under the revolving letter of credit subfacility and the synthetic letter of credit facility will be used in the ordinary course of business to secure workers compensation and other insurance coverages and for general corporate purposes.

As a result of the Recapitalization Transactions, we recorded an approximate $361.1 million *Loss on early extinguishment of debt* in the first quarter of 2006.

Offers to Purchase and Consent Solicitations

On February 2, 2006, we announced that we were offering to purchase, and soliciting consents seeking approval of proposed amendments to the indentures governing, our 7.375% Senior Notes due 2006, 7.000% Senior Notes due 2008, 8.500% Senior Notes due 2008, 8.375% Senior Notes due 2011, 7.625% Senior Notes due 2012, and our 10.750% Senior Subordinated Notes due 2008 (collectively, the Notes). On February 15, 2006, we announced that a majority in principal amount of the holders of our Notes had delivered consents under the indentures governing these Notes, thereby approving proposed amendments to the indentures.

Consents, Amendments, and Waivers

On February 15, 2006, we entered into a consent and waiver (the Consent) to our 10.375% Senior Subordinated Credit Agreement. Pursuant to the terms of the Consent, the lenders consented to the prepayment of all outstanding loans in full (together with all accrued and unpaid interest) on or prior to March 20, 2006 and waived certain provisions of the 10.375% Senior Subordinated Credit Agreement to the extent such provisions prohibited such prepayment. In connection with the Consent, we paid to each lender a prepayment premium equal to 15.0% of the principal amount of such lender s loans.

Also on February 15, 2006, we entered into an amendment and waiver (the Amendment) to our Term Loan Agreement. Pursuant to the terms of the Amendment, the lenders amended certain provisions of the Term Loan Agreement to the extent such provisions prohibited a prepayment of the loans thereunder prior to June 15, 2006. In connection with the Amendment, we paid a consent fee equal to 1.0% of the principal amount of such lender s loans. We also paid a prepayment fee equal to 2.0% of the aggregate principal amount of the prepayment.

On February 22, 2006, we entered into an amendment and waiver (the Waiver) to our Amended and Restated Credit Agreement. Pursuant to the terms of the Waiver, the lenders waived, in the event the recapitalization did not occur substantially simultaneously with the issuance of the convertible perpetual preferred stock, certain provisions of the Amended and Restated Credit Agreement to the extent required to permit us to apply 100% of the net proceeds of the issuance of the convertible perpetual preferred stock to the prepayment or repayment of other existing indebtedness. In connection with the Waiver, we paid to each lender executing the Waiver a waiver fee equal to 0.05% of the principal amount of such lender s loans.

Senior Credit Facility

On March 10, 2006, we entered into a credit agreement (the Credit Agreement) with a consortium of financial institutions (collectively, the Lenders). The Credit Agreement provides for credit of up to $2.55

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billion of senior secured financing. The $2.55 billion available under the Credit Agreement includes (1) a six-year $400 million revolving credit facility (the Revolving Loans), with a revolving letter of credit subfacility and swingline loan subfacility, (2) a six-year $100 million synthetic letter of credit facility, and (3) a seven-year $2.05 billion term loan facility (the Term Loan Facility). The Term Loan Facility amortizes in quarterly installments, commencing with the quarter ending on September 30, 2006, equal to 0.25% of the original principal amount thereof, with the balance payable upon the final maturity. Loans under the Credit Agreement bear interest at a rate of, at our option, (1) LIBOR, adjusted for statutory reserve requirements (Adjusted LIBOR) or (2) the higher of (a) the federal funds rate plus 0.5% and (b) JPMorgan Chase Bank, N.A. s (JPMorgan) prime rate, in each case, plus an applicable margin that varies depending upon our leverage ratio and corporate credit rating. We are also subject to a commitment fee of 0.5% per annum on the daily amount of the unutilized commitments under the Revolving Loans and synthetic letter of credit facility.

Our interest rate under the Credit Agreement was 8.5% at June 30, 2006. As of June 30, 2006, approximately $50.0 million was drawn in Revolving Loans, excluding approximately $20.6 million utilized under the revolving letter of credit subfacility. Approximately $100.0 million was utilized under the synthetic letter of credit facility as of June 30, 2006.

Pursuant to a Collateral and Guarantee Agreement (the Collateral and Guarantee Agreement), dated as of March 10, 2006, between us, our subsidiaries defined therein (collectively, the Subsidiary Guarantors) and JPMorgan, our obligations under the Credit Agreement are (1) secured by substantially all of our assets and the assets of the Subsidiary Guarantors and (2) guaranteed by the Subsidiary Guarantors. In addition to the Collateral and Guarantee Agreement, we and the Subsidiary Guarantors agreed to enter into mortgages with respect to certain of our material real property (excluding real property owned by the surgery centers segment or otherwise subject to preexisting liens and/or mortgages) in connection with the Credit Agreement. Our obligations under the Credit Agreement will be secured by the real property subject to such mortgages.

The Credit Agreement contains affirmative and negative covenants and default and acceleration provisions, including a minimum interest coverage ratio and a maximum leverage ratio that changes over time.

Interim Loan Agreement

On March 10, 2006, we and the Subsidiary Guarantors also entered into the Interim Loan Agreement (the Interim Loan Agreement) with a consortium of financial institutions (collectively, the Interim Lenders). The Interim Loan Agreement provided us with $1 billion of senior unsecured interim financing. The loans under the Interim Loan Agreement had an initial maturity date of March 10, 2007, but were paid off on June 14, 2006 with the proceeds from our private offering of $1.0 billion of senior notes discussed below. The proceeds of the loans under the Interim Loan Agreement were used to refinance a portion of our prior indebtedness and to pay fees and expenses related to such refinancing. Our obligations under the Interim Loan Agreement were guaranteed by the Subsidiary Guarantors. At the time the Interim Loan Agreement was repaid, interest under the Interim Loan Agreement was priced at Prime plus 3.5%, which was 11.5%.

The Interim Loan Agreement contained affirmative and negative covenants and default and acceleration provisions that were substantially similar to the Credit Agreement.

Interest Rate Swap

Under the Credit Agreement, we are required to enter into and maintain, for a period of at least three years after the effective date of the Credit Agreement, one or more swap agreements to effectively convert at least 50% of our consolidated total indebtedness (as defined in the Credit Agreement and excluding the Interim Loan

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Agreement) to fixed rates. Therefore, on March 23, 2006, we entered into an interest rate swap with Goldman Sachs Capital Markets L.P. that was retroactively effective as of March 10, 2006, which was the day we entered into the Credit Agreement. On March 28, 2006, the swap was syndicated and the following allocation of credit risk was made:

Goldman Sachs Capital Markets L.P.	33.4%
Wachovia Bank, N.A.	33.3%
JPMorgan	33.3%

The notional amount of the interest rate swap as of June 30, 2006 was $2.0 billion, but is subject to adjustment in accordance with an amortization schedule that correlates to required and expected payments under the Credit Agreement. We pay a fixed rate of 5.2% under the swap agreement. Net settlements are made quarterly on each March 10, June 10, September 10, and December 10, commencing on June 10, 2006. The above counterparties pay a floating rate based on 3-month LIBOR, which was 5.3% at June 12, 2006, which is the most recent interest rate set date. The termination date of the swap is March 10, 2011.

We entered into this swap based on the requirements under our Credit Agreement to convert the floating rate of the Credit Agreement to the fixed rate of the swap in an effort to limit our exposure to variability in interest payments caused by changes in LIBOR. As of June 30, 2006, we had not designated the relationship between the Credit Agreement and interest rate swap as a hedge under FASB Statement No. 133. Therefore, changes in the fair value of the interest rate swap during the three months ended June 30, 2006 and the six months ended June 30, 2006 have been included in current-period earnings as *Gain on interest rate swap*. The fair market value of the swap as of June 30, 2006 was approximately $16.5 million of which approximately $6.6 million is included in *Other current assets* in our condensed consolidated balance sheet, with the remaining residing in *Other long-term assets*.

Private Offering of $1.0 Billion of Senior Notes

On June 14, 2006, we completed a private offering of $1.0 billion aggregate principal amount of senior notes, which included $375.0 million in aggregate principal amount of floating rate senior notes due 2014 (the Floating Rate Notes) at par and $625.0 million aggregate principal amount of 10.75% senior notes due 2016 (the 2016 Notes) at 98.505% of par (collectively, the Senior Notes). The offering and sale of the Senior Notes were not registered under the Securities Act of 1933, as amended (the Securities Act), and the Senior Notes may not be reoffered or resold in the United States absent registration or an applicable exemption from registration requirements.

The Senior Notes were issued pursuant to separate indentures dated June 14, 2006 (each an indenture and together, the Indentures) among HealthSouth, the Subsidiary Guarantors (as defined in the Indentures), and The Bank of Nova Scotia Trust Company of New York, as trustee (the Trustee). Pursuant to the terms of the Indentures, the Senior Notes are senior unsecured obligations of HealthSouth and will rank equally with our senior indebtedness, senior to any of our subordinated indebtedness, and effectively junior to our secured indebtedness to the extent of the value of the collateral securing such indebtedness. Our obligations under the Senior Notes are jointly and severally guaranteed by all of our existing and future subsidiaries that guarantee (1) borrowings under our Credit Agreement or (2) certain of our debt.

We used the net proceeds from the private offering of the Senior Notes, along with cash on hand, to repay all borrowings outstanding under our Interim Loan Agreement.

Interest on the Senior Notes is payable in arrears on June 15 and December 15 of each year, commencing on December 15, 2006. We pay interest on overdue principal at the rate of 1.0% per annum in excess of the

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applicable rates described below and will pay interest on overdue installments of interest at such higher rate to the extent lawful.

Floating Rate Notes

The Floating Rate Notes mature on June 15, 2014 and bear interest at a per annum rate, reset semiannually, of LIBOR plus 6.0%, as determined by the calculation agent, which is initially the Trustee. Our interest rate as of June 30, 2006 was 11.4%.

On or after June 15, 2009, we will be entitled, at our option, to redeem all or a portion of the Floating Rate Notes upon not less than 30 nor more than 60 days notice, at the redemption prices, plus accrued interest to the redemption date, if redeemed during the twelve-month period commencing on June 15 of the years set forth below:

Period	Redemption Price*
2009	103.0%
2010	102.0%
2011	101.0%
2012 and thereafter	100.0%

* Expressed in percentage of principal amount

Prior to June 15, 2009, we are entitled, at our option, to redeem Floating Rate Notes in an aggregate principal amount not to exceed 35% of the aggregate principal amount of the Floating Rate Notes issued at a redemption price of 100%, plus a premium equal to the interest rate per annum on the Floating Rate Notes, plus accrued and unpaid interest to the redemption date, with the net cash proceeds from certain equity offerings, provided however, that at least 65% of such aggregate principal amount of the Floating Rate Notes remains outstanding after giving effect to such redemption and each such redemption occurs within 90 days after the date of the related equity offering.

2016 Notes

The 2016 Notes mature on June 15, 2016 and bear interest at a per annum rate of 10.75%.

On or after June 15, 2011, we will be entitled, at our option, to redeem all or a portion of the 2016 Notes upon not less than 30 nor more than 60 days notice, at the redemption prices, plus accrued interest to the redemption date (subject to the right of holders of the 2016 Notes of record on the relevant record date to receive interest due on the relevant interest payment date), if redeemed during the twelve-month period commencing on June 15 of the years set forth below:

Period	Redemption Price*
2011	105.375%
2012	103.583%
2013	101.792%
2014 and thereafter	100.000%

* Expressed in percentage of principal amount

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Prior to June 15, 2009, we are entitled, at our option, to redeem 2016 Notes in an aggregate principal amount not to exceed 35% of the aggregate principal amount of the 2016 Notes issued at a redemption price of 110.75%, plus accrued and unpaid interest to the redemption date, with the net cash proceeds from certain equity offerings, provided however, that at least 65% of the aggregate principal amount of 2016 Notes remains outstanding after giving effect to such redemption and each such redemption occurs within 90 days after the date of the related equity offering.

Floating Rate Notes and 2016 Notes

Notwithstanding the foregoing, prior to June 15, 2009 (in the case of the Floating Rate Notes) and June 15, 2011 (in the case of the 2016 Notes), we are entitled, at our option, to redeem all, but not less than all, of the Senior Notes at a redemption price equal to 100% of the principal amount of the Senior Notes plus a premium, and accrued and unpaid interest. The premium is equal to the greater of (1) 1.0% of the principal amount of the Senior Notes and (2) the excess of (a) the present value at such redemption date of (i) the redemption price of such Senior Notes on June 15, 2009 (in the case of the Floating Rate Notes) or June 15, 2011 (in the case of the 2016 Notes), plus (ii) all required remaining scheduled interest payments due on such Senior Notes through June 15, 2009 (in the case of the Floating Rate Notes) or June 15, 2011 (in the case of the 2016 Notes), computed using a discount rate equal to the applicable Adjusted Treasury Rate (as defined in the documents governing the Senior Notes), over (b) the principal amount of such Senior Notes on such redemption date.

Repurchase Upon a Change of Control

Upon the occurrence of a change in control (as defined in the Indentures), each holder of the Senior Notes may require us to repurchase all or a portion of the Senior Notes in cash at a price equal to 101% of the principal amount of the Senior Notes to be repurchased, plus accrued and unpaid interest. However, subject to certain exceptions, our Credit Agreement limits our ability to repurchase the Senior Notes prior to their maturity.

Covenants

The Senior Notes contain covenants that, among other things, limit our and certain of our subsidiaries ability to (1) incur additional debt, (2) make certain restricted payments, (3) consummate specified asset sales, (4) enter into transactions with affiliates, (5) incur liens, (6) pay dividends or make payments to us and our restricted subsidiaries, (7) enter into sale leaseback transactions, (8) merge or consolidate with another person, and (9) dispose of all or substantially all of our assets. The Indentures provide for events of default (subject in certain cases to grace and cure periods), which include nonpayment, breach of covenants in the Indentures, payment defaults or acceleration of other indebtedness, a failure to pay certain judgments and certain events of bankruptcy and insolvency. Generally, if an event of default occurs, the Trustee or holders of at least 25% in principal amount of the then outstanding Senior Notes of a series may declare the principal of and accrued but unpaid interest on all the Senior Notes of such series to be due and payable.

Registration Rights Agreement

In connection with the offering of the Senior Notes, we agreed, pursuant to a registration rights agreement, dated as of June 14, 2006 (the Registration Rights Agreement), on or prior to the day (the Filing Date) that is 30 days after we are required under the Securities Exchange Act of 1934 (the Exchange Act) to file our Report on Form 10-K with the SEC for the fiscal year ending December 31, 2006 (after giving effect to all applicable extensions under the Exchange Act), to file a registration statement (Exchange Offer Registration Statement) with the SEC with respect to a registered offer (the Registered Exchange Offer) to exchange each series of the Senior Notes for new notes (Exchange Notes) having terms substantially identical in all material respects to

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such series of Senior Notes, and use our reasonable best efforts to cause the Exchange Offer Registration Statement to be declared effective under the Securities Act no later than 180 days after the Filing Date. The Exchange Notes will generally be freely transferable under the Securities Act.

In addition, we have agreed under certain circumstances to file one or more shelf registration statements to cover resales of the Senior Notes. In the event that (1) applicable interpretations of the staff of the SEC do not permit us to effect a Registered Exchange Offer, (2) for any other reason the Registered Exchange Offer is not consummated by 220 days of the Filing Date, (3) an initial purchaser notifies us following consummation of the Registered Exchange Offer that Senior Notes held by such initial purchaser are not eligible to be exchanged for the Exchange Notes in the Registered Exchange Offer, or (4) certain holders of the Senior Notes are prohibited by law or SEC policy from participating in the Registered Exchange Offer or cannot resell the Exchange Notes acquired by them in the Registered Exchange Offer to the public without delivering a prospectus, we will, at our cost, (a) promptly file a shelf registration statement with the SEC covering resales of the applicable series of Notes or the Exchange Notes, as the case may be, (b) use our reasonable best efforts to cause the shelf registration statement to be declared effective under the Securities Act within a specified period of time, and (c) keep effective the shelf registration statement until two years after its effective date (subject to certain exceptions).

If we fail to satisfy these obligations and our other obligations as set forth in the Registration Rights Agreement, we will be required to pay additional interest to the holders of the Senior Notes. We agreed that if we do not (1) file an Exchange Offer Registration Statement with respect to a series of Senior Notes with the SEC on or prior to the Filing Date or (2) if the Exchange Offer Registration Statement or shelf registration statement described above is not declared effective (or ceases to be effective) or the exchange offers are not consummated within the specified time period (any event described in (1) and (2) being referred to individually as a Registration Default), then we will pay additional cash interest on the applicable series of Senior Notes. The rate of the additional interest will be 0.25% per annum for the first 90-day period immediately following the occurrence of a Registration Default, and such rate will increase by an additional 0.25% per annum with respect to each subsequent 90-day period until all Registration Defaults have been cured, up to a maximum additional interest rate of 1.0% per annum. We will pay such additional interest on regular interest payment dates. Such additional interest will be in addition to any other interest payable from time to time with respect to the applicable series of Senior Notes and Exchange Notes.

5. Convertible Perpetual Preferred Stock:

On March 7, 2006, we completed the sale of 400,000 shares of our 6.50% Series A Convertible Perpetual Preferred Stock (the Series A Preferred Stock). The Series A Preferred Stock has an initial liquidation preference of $1,000 per share of Series A Preferred Stock, which is contingently subject to accretion. Holders of Series A Preferred Stock are entitled to receive, when and if declared by our Board of Directors, cash dividends at the rate of 6.50% per annum on the accreted liquidation preference per share, payable quarterly in arrears on January 15, April 15, July 15, and October 15 of each year, commencing on July 15, 2006. Dividends on Series A Preferred Stock are cumulative. If we are prohibited by the terms of our credit facilities, debt indentures, or other debt instruments from paying cash dividends on the Series A Preferred Stock, we may pay dividends in shares of our common stock, or a combination of cash and shares of our common stock, if the shares of our common stock delivered as payment are freely transferable by the recipient thereof (other than by reason of the fact that the recipient is our affiliate) or if a shelf registration statement relating to that common stock is effective to permit the resale thereof. Shares of our common stock delivered as dividends will be valued at 95% of their market value. Unpaid dividends will accrete at an annual rate of 8.0% per year for the relevant dividend period and will be reflected as an accretion to the liquidation preference of the Series A Preferred Stock. The Series A Preferred Stock is convertible, at the option of the holder, at any time into shares of our common stock at an initial

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conversion price of $6.10 per share, which is equal to an initial conversion rate of approximately 163.9344 shares of common stock per share of Series A Preferred Stock, subject to specified adjustments. On or after July 20, 2011, we may cause the shares of Series A Preferred Stock to be automatically converted into shares of our common stock at the conversion rate then in effect if the closing sale price of our common stock for 20 trading days within a period of 30 consecutive trading days ending on the trading day before the date we give the notice of forced conversion exceeds 150% of the conversion price of the Series A Preferred Stock. If we are subject to a fundamental change, as defined in the Certificate of Designation of the Series A Preferred Stock, each holder of shares of Series A Preferred Stock has the right, subject to certain limitations, to require us to purchase any or all of its shares of Series A Preferred Stock at a purchase price equal to 100% of the accreted liquidation preference, plus any accrued and unpaid dividends to the date of purchase. In addition, if holders of the Series A Preferred Stock elect to convert shares of Series A Preferred Stock in connection with certain fundamental changes, we will in certain circumstances increase the conversion rate for such shares of Series A Preferred Stock. As redemption of the Series A Preferred Stock is contingent upon the occurrence of a fundamental change, and since we do not deem a fundamental change probable of occurring, accretion of our *Convertible perpetual preferred stock* is not necessary.

Each holder of Series A Preferred Stock has one vote for each share of Series A Preferred Stock held by the holder on all matters voted upon by the holders of our common stock, as well as voting rights specifically provided for in our restated certificate of incorporation or as otherwise from time to time required by law. In addition, if we fail to repurchase shares of Series A Preferred Stock following a fundamental change, then the holders of Series A Preferred Stock (voting separately as a class with all other series of preferred stock upon which like voting rights have been conferred and are exercisable) will be entitled to call a special meeting of our board of directors and, at the special meeting, vote for the election of two additional directors to our board of directors. The term of office of all directors so elected will terminate immediately upon our repurchase of those shares of Series A Preferred Stock.

The Series A Preferred Stock will be, with respect to dividend rights and rights upon liquidation, winding-up, or dissolution: (1) senior to all classes of our common stock and each other class of capital stock or series of preferred stock established after the original issue date of the Series A Preferred Stock (which we will refer to as the Issue Date), the terms of which do not expressly provide that such class or series ranks senior to or on a parity with the Series A Preferred Stock as to dividend rights or rights upon our liquidation, winding-up, or dissolution; (2) on a parity with any class of capital stock or series of preferred stock established after the Issue Date, the terms of which expressly provide that such class or series will rank on a parity with the Series A Preferred Stock as to dividend rights or rights upon our liquidation, winding-up, or dissolution; (3) junior to each class of capital stock or series of preferred stock established after the Issue Date, the terms of which expressly provide that such class or series will rank senior to the Series A Preferred Stock as to dividend rights or rights upon our liquidation, winding-up, or dissolution; and (4) junior to all our existing and future debt obligations and other liabilities, including claims of trade creditors.

We are required to use our reasonable best efforts to file on or prior to the day that is 30 days after we are required under the Exchange Act, as amended, to file our Report on Form 10-K with the SEC for the fiscal year ending December 31, 2006 (giving effect to any extensions under the Exchange Act) and have declared effective no later than 180 days after such date a shelf registration statement registering the Series A Preferred Stock and the common stock issuable upon the conversion of the Series A Preferred Stock, and to use our reasonable best efforts to cause such registration statement to remain effective until the earliest of two years following the date of issuance of the Series A Preferred Stock, the sale of all Series A Preferred Stock and common stock issuable upon the conversion of the Series A Preferred Stock under such registration statement and the date on which all Series A Preferred Stock and common stock issuable upon the conversion of the Series A Preferred Stock cease to be outstanding or have been resold pursuant to Rule 144 under the Securities Act. If we fail to comply with

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any of the foregoing requirements, then, in each case, we will pay additional dividends to all holders of Series A Preferred Stock equal to the applicable dividend rate or accretion rate for the relevant period plus (1) 0.25% per annum for the first 90 days after such registration default and (2) thereafter, 0.50% per annum.

As of June 30, 2006, declared and accrued dividends on our Series A Preferred Stock approximated $9.2 million and were included in *Accrued expenses and other current liabilities* on our balance sheet. These dividends were paid in July 2006.

6. Stock-Based Compensation:

Employee Stock-Based Compensation Plans

As of June 30, 2006, we had outstanding options from the 1995, 1997, 1999, and 2002 Stock Option Plans, the Key Executive Incentive Program, the 2005 Equity Incentive Plan, and several other stock option plans assumed from various acquisitions that occurred in prior years (collectively, the Option Plans). The Option Plans are designed to provide a performance incentive by issuing options to purchase shares of HealthSouth common stock to certain members of our board of directors, officers, and employees. The Option Plans provide for the granting of both incentive stock options and nonqualified stock options. The terms and conditions of the options, including exercise prices and the periods in which options are exercisable, generally are at the discretion of the Compensation Committee of the Board of Directors; however, no options are exercisable beyond approximately ten years from the date of grant and granted options vest over the awards requisite service periods, which can be up to five years depending on the type of award granted. As of June 30, 2006, the following Option Plans have authorized shares available to grant (in thousands):

Plan	Authorized Shares
1997	2,894
2002	5,172
2005 Equity Incentive	15,878
Total authorized shares	23,944

Restricted Stock

We can issue restricted common stock under the 1998 Restricted Stock Plan (the Restricted Stock Plan) to executives and key employees of HealthSouth. The terms of the Restricted Stock Plan make available up to 3,000,000 shares of common stock to be granted beginning in 1998 through 2008. Awards made under the Restricted Stock Plan vest over a three-year requisite service period. Fair value is determined by the market price of our common stock on the grant date. A summary of our restricted share awards from the Restricted Stock Plan is as follows (share information in thousands):

	Shares	Weighted Average Grant Date Fair Value
Nonvested shares at December 31, 2005	825	$ 5.26
Granted	450	5.30
Vested		
Forfeited	(30)	4.89
Nonvested shares at June 30, 2006	1,245	$ 5.29

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As of June 30, 2006, 1,580,000 shares had not been awarded and were available for future grants. Unrecognized compensation expense related to unvested shares was $3.7 million at June 30, 2006. We expect to recognize this expense over the next 32 months.

In November 2005, we also issued restricted common stock to our key executives under the Key Executive Incentive Program. Total issued grants consisted of 577,735 shares of restricted stock. The weighted-average fair value of the restricted shares was $3.87 per share, and the shares are subject to a three-year requisite service period with 25% of the shares vesting on January 1, 2007, 25% of the shares vesting on January 1, 2008, and 50% of the shares vesting on January 1, 2009. None of the awards made under this plan have vested at either December 31, 2005 or June 30, 2006. Unrecognized compensation expense related to the unvested shares was $1.4 million at June 30, 2006. We expect to recognize this expense over the next 31 months.

We recognized compensation expense under the Restricted Stock Plan and the Key Executive Incentive Program, which is included in *Salaries and benefits* in the accompanying condensed consolidated statements of operations and comprehensive loss, as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Compensation expense:				
Restricted Stock Plan	$ 423	$ 361	$ 858	$ 518
Key Executive Incentive Program	216		492	
	$ 639	$ 361	$ 1,350	$ 518

Stock Options

The fair values of the options granted during the three months ended June 30, 2006 and the six months ended June 30, 2006 have been estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Expected volatility	43.3%	46.4%
Risk-free interest rate	5.0%	4.6%
Expected life (years)	4.1	4.6
Dividend yield	0.0%	0.0%

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the expected stock price volatility. We estimate our expected term through an analysis of actual, historical post-vesting exercise, cancellation, and expiration behavior by our employees and projected post-vesting activity of outstanding options. We calculate volatility based on the historical volatility of our common stock over the period commensurate with the expected life of the options, excluding a distinct period of extreme volatility between 2002 and 2003. The risk-free interest rate is the implied daily yield currently available on U.S. Treasury issues with a remaining term closely approximating the expected term used as the input to the Black-Scholes option-pricing model. The Company does not pay a dividend, and we do not include a dividend payment as part of our pricing model. We estimate forfeitures through an analysis of actual, historical pre-vesting option cancellations. Under the Black-Scholes option-pricing model, the weighted- average fair value per share of employee stock options granted during the three months ended June 30, 2006 and

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2005 was $1.80 and $2.50, respectively. During the six months ended June 30, 2006 and 2005, the weighted-average fair value per share was $2.34 and $2.51, respectively.

A summary of our 2006 stock option activity and related information is as follows (in thousands, except price per share and remaining life):

	Shares	Weighted Average Exercise Price	Remaining Life (Years)	Aggregate Intrinsic Value
Outstanding, December 31, 2005	15,983	$ 6.70		
Granted	6,501	5.28		
Exercised				
Forfeitures	(1,002)	5.10		
Cancellations	(788)	8.78		
Expirations	(125)	18.13		
Outstanding, June 30, 2006	20,569	6.18	7.8	$ 321
Exercisable, June 30, 2006	8,922	7.53	6.2	$ 242

We recognized approximately $3.1 million and $5.8 million of compensation expense related to our stock options in the three months ended June 30, 2006 and the six months ended June 30, 2006, respectively. During the three months ended June 30, 2005 and the six months ended June 30, 2005, we followed the disclosure-only provisions of FASB Statement No. 123 and did not recognize any compensation expense. As of June 30, 2006, there was $19.3 million of unrecognized compensation cost related to unvested stock options. This cost is expected to be recognized over a weighted-average period of 2.1 years.

Non-Employee Stock-Based Compensation Plans

In 2004, the Special Committee of our board of directors (the Special Committee) adopted the 2004 Director Incentive Plan, as amended and restated, to provide incentives to our non-employee members of the Special Committee. Up to 2,000,000 shares may be granted pursuant to the 2004 Director Incentive Plan through the award of shares of unrestricted common stock, restricted shares of common stock (restricted stock), and/or through the award of a right to receive shares of common stock (RSUs). Restricted awards are subject to a three-year graded vesting period, while the RSUs are fully vested when awarded.

A summary of our 2006 restricted share awards activity from the 2004 Director Incentive Plan is as follows (share information in thousands):

	Shares	Weighted Average Grant Date Fair Value
Nonvested shares at December 31, 2005	97	$ 5.93
Granted		
Vested	(37)	5.85
Forfeited	(9)	5.80
Nonvested shares at June 30, 2006	51	$ 6.01

During the six months ended June 30, 2006, we issued 152,500 RSUs with a fair value of $5.31 per unit. These RSUs were fully vested on the grant date. Therefore, we recognized approximately $0.8 million of compensation expense upon their issuance. No RSUs were issued prior to January 1, 2006.

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As of June 30, 2006, 1,730,886 shares had not been awarded and were available for future grants under the 2004 Director Incentive Plan. Deferred compensation related to unvested shares was $0.1 million as of June 30, 2006. We expect to recognize this expense over the next 18 months.

We recognized compensation expense under the 2004 Director Incentive Plan and other individual restricted stock agreements, which is included in *Salaries and benefits* in the accompanying condensed consolidated statements of operations and comprehensive loss as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
2004 Director Incentive Plan and other individual agreements	$ 3	$ 257	$ 851	$ 350

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7. Discontinued Operations:

For the facilities identified during the three months ended June 30, 2006 that met the requirements of FASB Statement No. 144, we reclassified our condensed consolidated balance sheet as of December 31, 2005, presented our condensed consolidated statements of operations and comprehensive loss for the three and six months ended June 30, 2005, and presented our condensed consolidated statement of cash flows for the six months ended June 30, 2005 to show the results of those facilities as discontinued operations. The operating results of discontinued operations, by operating segment and in total, are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Inpatient:				
Net operating revenues	$ 194	$ 225	$ 338	$ 491
Costs and expenses	546	611	1,074	1,396
Impairments	1,836		1,836	
Loss from discontinued operations	(2,188)	(386)	(2,572)	(905)
Gain on disposal of assets of discontinued operations			69	362
Income tax expense				
Loss from discontinued operations	$ (2,188)	$ (386)	$ (2,503)	$ (543)
Surgery Centers:				
Net operating revenues	$ 496	$ 8,344	$ 2,136	$ 18,107
Costs and expenses	1,982	10,481	4,156	23,393
Loss from discontinued operations	(1,486)	(2,137)	(2,020)	(5,286)
Gain on disposal of assets of discontinued operations	960	3,125	6,389	2,860
Income tax expense				
(Loss) income from discontinued operations	$ (526)	$ 988	$ 4,369	$ (2,426)
Outpatient:				
Net operating revenues	$ 537	$ 5,041	$ 965	$ 11,157
Costs and expenses	693	6,246	1,758	13,205
Loss from discontinued operations	(156)	(1,205)	(793)	(2,048)
Gain (loss) on disposal of assets of discontinued operations	8	(13)	(266)	455
Income tax expense				
Loss from discontinued operations	$ (148)	$ (1,218)	$ (1,059)	$ (1,593)
Diagnostic:				
Net operating revenues	$ 311	$ 1,212	$ 828	$ 3,182
Costs and expenses	944	2,094	2,142	4,951
Impairments	434		958	
Loss from discontinued operations	(1,067)	(882)	(2,272)	(1,769)
(Loss) gain on disposal of assets of discontinued operations	(55)	(162)	(431)	587
Income tax expense				

Loss from discontinued operations	$ (1,122)	$ (1,044)	$ (2,703)	$ (1,182)
Corporate and Other:				
Net operating revenues	$ 3,572	$ 22,192	$ 14,216	$ 56,070
Costs and expenses	3,996	27,567	23,008	69,009
Impairments				6,589
Loss from discontinued operations	(424)	(5,375)	(8,792)	(19,528)
(Loss) gain on disposal of assets of discontinued operations	(1)	86	(7,306)	257
Income tax expense				
Loss from discontinued operations	$ (425)	$ (5,289)	$ (16,098)	$ (19,271)
Total:				
Net operating revenues	$ 5,110	$ 37,014	$ 18,483	$ 89,007
Costs and expenses	8,161	46,999	32,138	111,954
Impairments	2,270		2,794	6,589
Loss from discontinued operations	(5,321)	(9,985)	(16,449)	(29,536)
Gain (loss) on disposal of assets of discontinued operations	912	3,036	(1,545)	4,521
Income tax expense				
Loss from discontinued operations	$ (4,409)	$ (6,949)	$ (17,994)	$ (25,015)

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The assets and liabilities of discontinued operations consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Assets:		
Cash and cash equivalents	$ 1,063	$ 1,977
Accounts receivable, net	3,720	8,138
Other current assets	4,141	3,183
Total current assets	8,924	13,298
Property and equipment, net	11,144	42,973
Intangible assets, net	708	744
Other long-term assets	4,709	4,663
Total long-term assets	16,561	48,380
Total assets	$ 25,485	$ 61,678
Liabilities:		
Current portion of long-term debt	$ 30	$ 2,129
Accounts payable and other current liabilities	3,265	773
Total current liabilities	3,295	2,902
Long-term debt, net of current portion		6,426
Other long-term liabilities	4,702	989
Total long-term liabilities	4,702	7,415
Total liabilities	$ 7,997	$ 10,317

On July 20, 2005, we executed an asset purchase agreement with The Board of Trustees of the University of Alabama (the University of Alabama) for the sale of the real property, furniture, fixtures, equipment, and certain related assets associated with our 219 licensed-bed acute care hospital located in Birmingham, Alabama (the Birmingham Medical Center) for $33.0 million. Simultaneously with the execution of this purchase agreement with the University of Alabama, we executed an agreement with an affiliate of the University of Alabama whereby this entity provided certain management services to the Birmingham Medical Center. On December 31, 2005, we executed an amended and restated asset purchase agreement with the University of Alabama. This amended and restated agreement provided that the University of Alabama purchase the Birmingham Medical Center and associated real and personal property as well as our interest in the gamma knife partnership associated with this hospital. This transaction closed on March 31, 2006 and resulted in a net loss on disposal of assets of approximately $7.3 million.

We have transferred the hospital and associated real and personal property, but will transfer our interest in the gamma knife partnership at a later date. Both the certificate of need under which the hospital operated and the licensed beds operated by us at the hospital were transferred as part of the sale of the hospital under the amended and restated agreement. The transaction also required that we acquire and convey title to the University of Alabama or its affiliate for certain professional office buildings that we leased. During the course of negotiations with the landlord of these properties, we agreed to continue certain rent payment obligations related to the terminated lease. The costs to terminate the lease associated with the professional office buildings approximated $29 million. These lease termination costs are the primary factor that contributed to the $7.3 million net loss on disposal of assets.

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After consummation of this agreement with the University of Alabama, we no longer have the ability to operate or sell the Digital Hospital project as an acute care hospital without obtaining an additional certificate of need or specific exception. For additional information related to the Digital Hospital, see our 2005 Form 10-K.

8. Income Taxes:

Our *Provision for income tax expense* for the three months ended June 30, 2006 includes the following: (1) current income tax expense of $5.2 million in continuing operations attributable to state income taxes of subsidiaries which have separate state tax filing requirements and income taxes for other subsidiaries that are not included in our federal consolidated income tax return, and (2) deferred income tax expense of $3.9 million in continuing operations attributable to future tax liabilities to be incurred by subsidiaries that are not included in our federal consolidated income tax return and increases in the basis difference of certain indefinite-lived assets.

Our *Provision for income tax expense* for the six months ended June 30, 2006 includes the following: (1) current income tax expense of $10.9 million in continuing operations attributable to state income taxes of subsidiaries which have separate state tax filing requirements and income taxes for other subsidiaries that are not included in our federal consolidated income tax return, and (2) deferred income tax expense of $16.1 million in continuing operations attributable to future tax liabilities to be incurred by subsidiaries that are not included in our federal consolidated income tax return and increases in the basis difference of certain indefinite-lived assets.

We have significant federal and state net operating losses. We assess the realization of our deferred tax assets quarterly to determine whether an adjustment to the valuation allowance is required. After consideration of all evidence, both positive and negative, management concluded that it is more likely than not that we will not realize a portion of our deferred tax assets. Therefore, a valuation allowance has been established on substantially all of our net deferred tax assets. No valuation allowance has been provided on deferred assets and liabilities attributable to subsidiaries not included within the federal consolidated group. The valuation allowance for the quarter also increased in part as a result of certain deferred tax liabilities that are indefinite-lived, which inherently means that the reversal period of these liabilities is unknown. Therefore, for scheduling the expected utilization of deferred tax assets as required by FASB Statement No. 109, these indefinite-lived liabilities cannot be looked upon as a source of future taxable income, and an additional valuation allowance must be established.

Our *Provision for income tax expense* for the same periods in 2005 consisted of substantially the same items of current and deferred taxes. Income tax expense for the six months ended June 30, 2006 increased due to the fact that we filed a request for a tax accounting method change which accelerated the amortization of certain indefinite-lived assets. This tax accounting method change gave rise to an additional difference between the book and tax bases of the assets effected and, accordingly, resulted in our recording an additional deferred tax liability and deferred tax expense related to these indefinite-lived assets. The entire impact of this change of approximately $8.3 million was reflected in the three months ended March 31, 2006.

On May 18, 2006, the State of Texas enacted a new law that substantially changes the state s business franchise tax system, replacing the existing franchise tax with a new franchise tax that is based upon modified gross revenue. This new tax regime, known as the Margin Tax , expands the tax base while reducing tax rates. The Margin Tax will take effect beginning with our 2007 calendar year. The Texas Legislature and the Texas State s Comptroller s office are still reviewing certain provisions of the new law which could have an impact on how we compute our current and deferred tax accounts associated with our Texas operations. We will continue to monitor guidance from Texas regarding the application of this change in the tax law. We do not believe this law change will have a material impact on our financial position, results of operations, or cash flows.

HealthSouth and its subsidiaries federal and state income tax returns are periodically examined by various regulatory taxing authorities. In connection with such examinations, we have settled our federal income tax

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liabilities with the Internal Revenue Service (the IRS) for the tax years 1994 1995. During the six months ended June 30, 2006, we received tax refunds and interest in the amount of $22.4 million as a result of this settlement. In May 2006, we received the IRS report and assessment of additional income taxes for the years 1996 1998. We filed a formal reply in July 2006 and are currently working to resolve these matters. Amounts related to these tax deficiencies and other contingencies have been considered by management in its estimate of our potential net recovery of prior income taxes.

9. Loss per Common Share:

The calculation of loss per common share is based on the weighted-average number of our common shares outstanding during the applicable period. The calculation for diluted loss per common share recognizes the effect of all dilutive potential common shares that were outstanding during the respective periods, unless their impact would be antidilutive. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Numerator:				
Loss from continuing operations	$ (38,027)	$ (55,464)	$ (459,580)	$ (295,602)
Less: Convertible perpetual preferred dividends	(9,244)		(9,244)	
Loss from continuing operations available to common shareholders	(47,271)	(55,464)	(468,824)	(295,602)
Loss from discontinued operations	(4,409)	(6,949)	(17,994)	(25,015)
Net loss available to common shareholders	$ (51,680)	$ (62,413)	$ (486,818)	$ (320,617)
Denominator:				
Basic weighted average common shares outstanding	398,165	397,047	397,725	396,529
Diluted weighted average common shares outstanding	464,511	398,827	439,411	398,693
Basic and diluted loss per share:				
Loss from continuing operations available to common shareholders	$ (0.12)	$ (0.14)	$ (1.18)	$ (0.75)
Loss from discontinued operations	(0.01)	(0.02)	(0.04)	(0.06)
Net loss per share available to common shareholders	$ (0.13)	$ (0.16)	$ (1.22)	$ (0.81)

Diluted earnings per share report the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. These potential shares include dilutive stock options, restricted stock awards, convertible debentures, restricted stock units, and convertible perpetual preferred stock. For the three months ended June 30, 2006 and 2005, the number of potential shares approximated 66.3 million and 1.8 million, respectively. For the six months ended June 30, 2006 and 2005, the number of potential shares approximated 41.7 million and 2.2 million, respectively. Including these potential common shares in the denominator resulted in an antidilutive per share amount due to our *Loss from continuing operations*. Therefore, no separate computation of diluted loss per share is presented.

Options to purchase approximately 20.1 million and 5.2 million shares of common stock were outstanding as of June 30, 2006 and 2005, respectively, but were not included in the computation of diluted weighted-average shares because to do so would have been antidilutive.

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We repaid our 3.25% Convertible Debentures which were due April 1, 2003 from the net proceeds of a loan arranged by Credit Suisse First Boston on January 16, 2004. In connection with this transaction, we issued warrants to the lender to purchase ten million shares of our common stock. Each warrant has a term of ten years from the date of issuance and an exercise price of $6.50 per share. The warrants were not assumed exercised for dilutive shares outstanding because they were antidilutive in the period.

As discussed in more detail in Note 5, *Convertible Perpetual Preferred Stock*, in March 2006, we issued 400,000 shares of convertible perpetual preferred stock as part of a recapitalization of HealthSouth. We use the if-converted method to include the convertible perpetual preferred stock in our computation of diluted loss per share.

In February 2006, we agreed to issue approximately 25.1 million common shares and approximately 40.8 million common stock warrants to settle our class action securities litigation. For additional information, see Note 10, *Settlements*.

10. Settlements:

Medicare Program Settlement

Pursuant to the global settlement agreement, as described in our 2005 Form 10-K, we agreed to make cash payments to the United States in the aggregate amount of $325 million, plus accrued interest from November 4, 2004 at an annual rate of 4.125%. Through June 30, 2006, we have made payments of approximately $196.3 million (excluding interest), with the remaining balance of $128.7 million (plus interest) to be paid in quarterly installments ending in the fourth quarter of 2007. As of June 30, 2006 and December 31, 2005, approximately $85.0 million and $83.3 million, respectively, of the cash settlement amount are included in *Current portion of government, class action, and related settlements* in our condensed consolidated balance sheets.

SEC Settlement

Under the terms of our settlement with the SEC, as described in our 2005 Form 10-K, we agreed to pay a $100 million civil penalty and disgorgement of $100 to the SEC in the following installments: $12,500,100 by October 15, 2005; $12.5 million by April 15, 2006; $25.0 million by October 15, 2006; $25.0 million by April 15, 2007; and $25.0 million by October 15, 2007. As of the date of this filing, we are current with all payments required under the above payment schedule. Payments due under the SEC Settlement are included in *Government, class action, and related settlements* in our condensed consolidated balance sheets.

Securities Litigation Settlement

On June 24, 2003, the United States District Court for the Northern District of Alabama consolidated a number of separate securities lawsuits filed against us under the caption *In re HealthSouth Corp. Securities Litigation*, Master Consolidation File No. CV-03-BE-1500-S (the Consolidated Securities Action). The Consolidated Securities Action included two prior consolidated cases (*In re HealthSouth Corp. Securities Litigation*, CV-98-J-2634-S and *In re HealthSouth Corp. 2002 Securities Litigation*, Consolidated File No. CV-02-BE-2105-S) as well as six lawsuits filed in 2003. Including the cases previously consolidated, the Consolidated Securities Action comprised over 40 separate lawsuits. The court divided the Consolidated Securities Action into two subclasses:

Complaints based on purchases of our common stock were grouped under the caption *In re HealthSouth Corp. Stockholder Litigation*, Consolidated Case No. CV-03-BE-1501-S (the Stockholder Securities Action), which was further divided into complaints based on purchases of our common stock in the

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open market (grouped under the caption *In re HealthSouth Corp. Stockholder Litigation,* Consolidated Case No. CV-03-BE-1501-S) and claims based on the receipt of our common stock in mergers (grouped under the caption *HealthSouth Merger Cases*, Consolidated Case No. CV-98-2777-S). Although the plaintiffs in the *HealthSouth Merger Cases* have separate counsel and have filed separate claims, the *HealthSouth Merger Cases* are otherwise consolidated with the Stockholder Securities Action for all purposes.

Complaints based on purchases of our debt securities were grouped under the caption *In re HealthSouth Corp. Bondholder Litigation*, Consolidated Case No. CV-03-BE-1502-S (the Bondholder Securities Action).

On January 8, 2004, the plaintiffs in the Consolidated Securities Action filed a consolidated class action complaint. The complaint names us as a defendant, as well as more than 30 of our current and former employees, officers and directors, the underwriters of our debt securities, and our former auditor. The complaint alleges, among other things, (1) that we misrepresented or failed to disclose certain material facts concerning our business and financial condition and the impact of the Balanced Budget Act of 1997 on our operations in order to artificially inflate the price of our common stock, (2) that from January 14, 2002 through August 27, 2002, we misrepresented or failed to disclose certain material facts concerning our business and financial condition and the impact of the changes in Medicare reimbursement for outpatient therapy services on our operations in order to artificially inflate the price of our common stock, and that some of the individual defendants sold shares of such stock during the purported class period, and (3) that Richard M. Scrushy instructed certain former senior officers and accounting personnel to materially inflate our earnings to match Wall Street analysts expectations, and that senior officers of HealthSouth and other members of a self-described family held meetings to discuss the means by which our earnings could be inflated and that some of the individual defendants sold shares of our common stock during the purported class period. The consolidated class action complaint asserts claims under Sections 11, 12(a)(2) and 15 of the Securities Act, and claims under Sections 10(b), 14(a), 20(a) and 20A of the 1934 Act.

On February 22, 2006, we announced that we had reached a global, preliminary agreement in principle with the lead plaintiffs in the Stockholder Securities Action, the Bondholder Securities Action, and the derivative litigation, as well as with our insurance carriers, to settle claims filed in those actions against us and many of our former directors and officers. Under the proposed settlement, claims brought against the settling defendants will be settled for consideration consisting of HealthSouth common stock and warrants valued at approximately $215 million and cash payments by our insurance carriers of $230 million. In addition, we have agreed to give the class 25% of our net recovery from any future judgments won by us or on our behalf against Richard M. Scrushy, our former Chairman and Chief Executive Officer, Ernst & Young LLP, our former auditor, and certain affiliates of UBS Group, our former lead investment banker, none of whom are included in the settlement. The proposed settlement is subject to a number of conditions, including the successful negotiation of definitive documentation and final court approval. The proposed settlement does not include Richard M. Scrushy or any director or officer who has agreed to plead guilty or otherwise been convicted in connection with our former financial reporting activities.

There can be no assurances that a final settlement agreement can be reached or that the proposed settlement will receive the required court approval. We recorded a charge of $215 million as *Government, class action, and related settlements expense* in our 2005 condensed consolidated statement of operations and comprehensive loss. The corresponding liability is included in *Current portion of government, class action, and related settlements* in our condensed consolidated balance sheets as of June 30, 2006 and December 31, 2005. This charge may be revised in future periods to reflect additional changes in the fair value of the common stock and warrants until they are issued.

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Non-Prosecution Agreement

On May 17, 2006, we announced that we reached a non-prosecution agreement (the Non-Prosecution Agreement) with the United States Department of Justice (the DOJ) with respect to the accounting fraud committed by members of our former management. We have pledged to continue our cooperation with the DOJ and have paid $3 million to the U.S. Postal Inspection Services Consumer Fraud Fund during the three months ended June 30, 2006 in connection with the execution of the Non-Prosecution Agreement. This payment was recorded in *Government, class action, and related settlements expense* in our condensed consolidated statements of operations and comprehensive loss.

Notwithstanding the foregoing, the DOJ has reserved the right to prosecute the Company for any crimes committed by our employees in the event we violate the terms of the Non-Prosecution Agreement. The Non-Prosecution Agreement expires on May 17, 2009.

11. Contingencies:

Significant Legal Proceedings

We operate in a highly regulated and litigious industry. As a result, various lawsuits, claims, and legal and regulatory proceedings have been and can be expected to be instituted or asserted against us. The resolution of any such lawsuits, claims, or legal and regulatory proceedings could materially and adversely affect our results of operations and financial position in a given period.

Securities Litigation

See Note 10, *Settlements*, Securities Litigation Settlement, for discussion of a global, preliminary agreement in principle with the lead plaintiffs in certain securities actions.

On November 24, 2004, an individual securities fraud action captioned *Burke v. HealthSouth Corp., et al.*, 04-B-2451 (OES), was filed in the United States District Court of Colorado against us, some of our former directors and officers, and our former auditor. The complaint makes allegations similar to those in the Consolidated Securities Action and asserts claims under the federal securities laws and Colorado state law based on plaintiff s alleged receipt of unexercised options and his open-market purchases of our stock. By order dated May 3, 2005, the action was transferred to the United States District Court for the Northern District of Alabama, where it remains pending. We intend to vigorously defend ourselves in this case. At this time, based on the stage of litigation, and review of the current facts and circumstances, we are unable to determine an amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case or whether any resultant liability would have a material adverse effect on our financial position, results of operations, or cash flows.

Derivative Litigation

Between 1998 and 2004, a number of lawsuits purporting to be derivative actions (*i.e.*, lawsuits filed by shareholder plaintiffs on our behalf) were filed in several jurisdictions, including the Circuit Court for Jefferson County, Alabama, the Delaware Court of Chancery, and the United States District Court for the Northern District of Alabama. All derivative complaints filed in the Circuit Court of Jefferson County, Alabama since 2002 have been consolidated and stayed in favor of the first-filed action captioned *Tucker v. Scrushy*, No. CV-02-5212, filed August 28, 2002. The *Tucker* complaint names as defendants a number of former HealthSouth officers and directors. *Tucker* also asserts claims on our behalf against Ernst & Young LLP, UBS Group, UBS Investment Bank, and UBS Securities, LLC, as well as against MedCenterDirect.com, Source Medical Solutions, Inc.,

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Capstone Capital Corp., Healthcare Realty Trust, and G.G. Enterprises. When originally filed, the primary allegations in the *Tucker* case involved self-dealing by Richard M. Scrushy and other insiders through transactions with various entities allegedly controlled by Mr. Scrushy. The complaint was amended four times to add additional defendants and include claims of accounting fraud, improper Medicare billing practices, and additional self-dealing transactions.

On January 3, 2006, the Alabama Circuit Court in the *Tucker* case granted the plaintiff s motion for summary judgment against Mr. Scrushy on a claim for the restitution of incentive bonuses Scrushy received for years 1996 through 2002. Including pre-judgment interest, the court s total award was approximately $48 million. The judgment does not resolve other claims brought by the plaintiff against Scrushy, which remain pending. On February 8, 2006, the Alabama Supreme Court stayed execution on the judgment and ordered briefing on whether or not the Alabama Circuit Court s order was appropriate for certification as a final appealable order pursuant to Rule 54(b). On April 12, 2006, the Alabama Supreme Court lifted its stay of execution on the judgment and ruled that the Alabama Circuit Court s order was appropriate for certification as a final appealable order. The Alabama Circuit Court s order granting summary judgment remains on appeal. As of the date of this report, the plaintiff has not executed the judgment.

The parties to the *Tucker* action have reached a preliminary agreement in principle to settle certain claims against many of our former directors and officers for $100 million in cash. This settlement amount is to be paid by our insurance carriers, and will be included in the aggregate cash payment of $230 million that is part of the proposed settlement of the Consolidated Securities Action. We are continuing to negotiate the other terms of a settlement with the other parties to this agreement; however, there can be no assurance that a final settlement agreement will be reached or that the proposed settlement will receive the required court approval.

On September 8, 2003, a derivative lawsuit captioned *Teachers Retirement Sys. of Louisiana v. Scrushy*, C.A. No. 20529-NC, was filed in the Delaware Court of Chancery. The complaint contains allegations similar to those made in the *Tucker* case, class claims, as well as a request for relief seeking an order compelling us to hold an annual meeting of stockholders. On December 2, 2003, we announced a settlement of the plaintiff s claims seeking an annual meeting of stockholders. The Court of Chancery has stayed the remaining claims in favor of earlier-filed litigation in Alabama. This case was not consolidated with *In re HealthSouth Corp. Shareholders Litigation*.

Litigation by and Against Former Independent Auditor

On March 18, 2005, Ernst & Young LLP filed a lawsuit captioned *Ernst & Young LLP v. HealthSouth Corp.*, CV-05-1618, in the Circuit Court of Jefferson County, Alabama. The complaint asserts that the filing of the claims against us was for the purpose of suspending any statute of limitations applicable to those claims. The complaint alleges that we provided Ernst & Young LLP with fraudulent management representation letters, financial statements, invoices, bank reconciliations, and journal entries in an effort to conceal accounting fraud. Ernst & Young LLP claims that as a result of our actions, Ernst & Young LLP s reputation has been injured and it has and will incur damages, expense, and legal fees. Ernst & Young LLP seeks recoupment and setoff of any recovery against Ernst & Young LLP in the *Tucker* case, as well as litigation fees and expenses, damages for loss of business and injury to reputation, and such other relief to which it may be entitled. On April 1, 2005, we answered Ernst & Young LLP s claims and asserted counterclaims alleging, among other things, that from 1996 through 2002, when Ernst & Young LLP served as our independent auditor, Ernst & Young LLP acted recklessly and with gross negligence in performing its duties, and specifically that Ernst & Young LLP failed to perform reviews and audits of our financial statements with due professional care as required by law and by its contractual agreements with us. Our counterclaims further allege that Ernst & Young LLP either knew of or, in

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the exercise of due care, should have discovered and investigated the fraudulent and improper accounting practices being directed by Richard M. Scrushy and certain other officers and employees, and should have reported them to our board of directors and the Audit Committee. The counterclaims seek compensatory and punitive damages, disgorgement of fees received from us by Ernst & Young LLP, and attorneys fees and costs. Upon Ernst & Young LLP s motion, the Alabama state court referred Ernst & Young LLP s claims and HealthSouth s counterclaims to arbitration. On July 12, 2006, the derivative plaintiff filed an arbitration demand on behalf of HealthSouth against Ernst & Young LLP.

We intend to vigorously defend ourselves in this case. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case.

ERISA Litigation

In 2003, six lawsuits were filed in the United States District Court for the Northern District of Alabama against us and some of our current and former officers and directors alleging breaches of fiduciary duties in connection with the administration of our Employee Stock Benefit Plan (the ESOP). These lawsuits were consolidated under the caption *In re HealthSouth Corp. ERISA Litigation*, Consolidated Case No. CV-03-BE-1700-S (the ERISA Action). The plaintiffs filed a consolidated complaint on December 19, 2003 that alleged, generally, that fiduciaries to the ESOP breached their duties to loyally and prudently manage and administer the ESOP and its assets in violation of sections 404 and 405 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.* (ERISA), by failing to monitor the administration of the ESOP, failing to diversify the portfolio held by the ESOP, and failing to provide other fiduciaries with material information about the ESOP. The plaintiffs sought actual damages including losses suffered by the plan, imposition of a constructive trust, equitable and injunctive relief against further alleged violations of ERISA, costs pursuant to 29 U.S.C. § 1132(g), and attorneys fees. The plaintiffs also sought damages related to losses under the plan as a result of alleged imprudent investment of plan assets, restoration of any profits made by the defendants through use of plan assets, and restoration of profits that the plan would have made if the defendants had fulfilled their fiduciary obligations. Pursuant to an Amended Class Action Settlement Agreement entered into on March 6, 2006, all parties have agreed to a global settlement of the claims in the ERISA Action. Under the terms of this settlement, Michael Martin, a former Chief Financial Officer of the Company, will contribute $350,000 to resolve claims against him, Richard Scrushy, former Chief Executive Officer of the Company, and our insurance carriers will contribute $3.5 million to resolve claims against him, and HealthSouth and its insurance carriers will contribute $25 million to settle claims against all remaining defendants, including HealthSouth. In addition, if we recover any or all of the judgment against Mr. Scrushy for the restitution of incentive bonuses paid to him during 1996 through 2002, we will contribute the first $1 million recovered to the class in the ERISA Action. On June 28, 2006, the Court granted final approval to the Amended Class Action Settlement Agreement and the ERISA Action was dismissed with prejudice.

Insurance Coverage Litigation

In 2003, approximately 14 insurance companies filed complaints in state and federal courts in Alabama, Delaware, and Georgia alleging that the insurance policies issued by those companies to us and/or some of our directors and officers should be rescinded on grounds of fraudulent inducement. The complaints also seek a declaration that we and/or some of our current and former directors and officers are not covered under various insurance policies. These lawsuits challenge the majority of our director and officer liability policies, including our primary director and officer liability policy in effect for the claims at issue. Actions filed by insurance companies in the United States District Court for the Northern District of Alabama were consolidated for pretrial and discovery purposes under the caption *In re HealthSouth Corp. Insurance Litigation*, Consolidated Case No.

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CV-03-BE-1139-S. Four lawsuits filed by insurance companies in the Circuit Court of Jefferson County, Alabama have been consolidated with the *Tucker* case for discovery and other pretrial purposes. Cases related to insurance coverage that were filed in Georgia and Delaware have been dismissed. We have filed counterclaims against a number of the plaintiffs in these cases alleging, among other things, bad faith for wrongful failure to provide coverage.

On February 22, 2006, we announced that we had reached a preliminary agreement in principle with our insurance carriers to resolve our claims against each other. In the proposed settlement, the carriers will contribute $230 million in cash toward the settlement of both the Consolidated Securities Action and the *Tucker* derivative litigation. However, there can be no assurances that a final settlement agreement can be reached.

We intend to continue to vigorously defend ourselves in these cases. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to determine our likelihood of prevailing in these cases, or any financial impact that may result from an adverse judgment in these cases if the proposed settlement is not finalized or approved by the court.

Litigation by and Against Richard M. Scrushy

After the dismissal of several lawsuits filed against us by Richard M. Scrushy, on December 9, 2005, Mr. Scrushy filed a complaint in the Circuit Court of Jefferson County, Alabama, captioned *Scrushy v. HealthSouth*, CV-05-7364. The complaint alleges that, as a result of Mr. Scrushy s removal from the position of CEO in March 2003, we owe him in excess of $70 million pursuant to an employment agreement dated as of September 17, 2002. We have answered the complaint and filed counterclaims against Mr. Scrushy. In addition, on or about December 19, 2005, Mr. Scrushy filed a demand for arbitration with the American Arbitration Association, supposedly pursuant to an indemnity agreement with us. The arbitration demand seeks to require us to pay expenses which he estimates exceed $31 million incurred by Mr. Scrushy, including attorneys fees, in connection with the defense of criminal fraud claims against him and in connection with a preliminary hearing in the SEC litigation. In our counterclaim filed in the Alabama Circuit Court action, we asked the court to prohibit Mr. Scrushy from having his claims resolved in arbitration, as opposed to a jury trial.

After hearings on January 4, 2006 and January 23, 2006, the Alabama Circuit Court denied our motion to stay and enjoin the arbitration. However, the court ordered Mr. Scrushy to terminate the arbitration and withdraw his demand for arbitration, but left him the option of beginning arbitration at a later date on further order of the court. The court also granted Mr. Scrushy the right to petition the court to lift the stay after pre-trial discovery had occurred in the court proceeding between us and Mr. Scrushy. On or about February 6, 2006, Mr. Scrushy filed a motion with the Alabama Supreme Court asking it to direct the Alabama Circuit Court to vacate its order requiring Mr. Scrushy to withdraw his arbitration demand, and to direct the Alabama Circuit Court to dismiss our counterclaim for a declaratory judgment and end any further exercise of jurisdiction over this arbitration matter. The Alabama Supreme Court granted Mr. Scrushy s request and the Alabama Circuit Court subsequently vacated its order, thereby allowing Mr. Scrushy to proceed with his claim in arbitration, which is a confidential proceeding.

While we dispute Mr. Scrushy s right to any indemnification of his defense fees and costs, we previously accrued an estimate of these legal fees as of December 31, 2005 and 2004, which is included in *Accrued expenses and other current liabilities*, in our condensed consolidated balance sheets as of June 30, 2006 and December 31, 2005. We intend to vigorously defend ourselves in this case. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case.

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Litigation by Other Former Officers

On August 22, 2003, Anthony Tanner, our former Secretary and Executive Vice President Administration, filed a petition in the Circuit Court of Jefferson County, Alabama, captioned *In re Tanner*, CV-03-5378, seeking permission to obtain certain information through the discovery process prior to filing a lawsuit. That petition was voluntarily dismissed with prejudice on August 11, 2004. On December 29, 2004, Mr. Tanner filed a lawsuit in the Circuit Court of Jefferson County, Alabama, captioned *Tanner v. HealthSouth Corp*., CV-04-7715, alleging that we breached his employment contract by failing to pay certain retirement benefits. The complaint requests damages, a declaratory judgment, and a preliminary injunction to require payment of past due amounts under the contract and reinstatement of the claimed retirement benefits. The parties settled this case pursuant to a General Release executed on March 21, 2006 and filed a Joint Stipulation of Dismissal with the court on March 24, 2006. The settlement did not have a material effect on our financial position, results of operations, or cash flows.

Litigation Against Former Officers

On June 10, 2004, we filed a collection action in the Circuit Court of Jefferson County, Alabama, captioned *HealthSouth Corp. v. James Goodreau*, CV-04-3619, to collect unpaid loans in the original principal amount of $55,500 that we made to James A. Goodreau, our former Director of Corporate Security, while he was a HealthSouth employee. Mr. Goodreau has asserted counterclaims against us seeking monetary damages in an unspecified amount and equitable relief based upon his contention that he was promised lifetime employment with us by Mr. Scrushy. This case is still pending. We intend to vigorously defend ourselves against the counterclaims alleged by Mr. Goodreau. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount or range of possible gain or loss that might result from a judgment or a settlement of this case.

On July 28, 2005, we filed a collection action in the Circuit Court of Jefferson County, Alabama captioned *HealthSouth Corp. v. William T. Owens*, CV-05-4420, to collect unpaid loans in the original principal amount of approximately $1.0 million that we made to William T. Owens, our former Chief Financial Officer, while he was a HealthSouth employee. On March 27, 2006, the court entered a Final Judgment in our favor and against Mr. Owens for approximately $1.4 million, which includes principal, accrued interest, and our attorneys fees.

Certain Regulatory Actions

The False Claims Act, 18 U.S.C. § 287, allows private citizens, called relators, to institute civil proceedings alleging violations of the False Claims Act. These so-called *qui tam*, or whistleblower, cases are sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government, and the presiding court. We recently settled one *qui tam* lawsuit, *Devage*, which is discussed in Note 21, *Medicare Program Settlement*, to the consolidated financial statements accompanying our 2005 Form 10-K. We are aware of one other *qui tam* lawsuit, *Mathews*, which is discussed below. It is possible that additional *qui tam* lawsuits have been filed against us and that we are unaware of such filings or have been ordered by the presiding court not to discuss or disclose the filing of such lawsuits. We may be subject to liability under one or more undisclosed *qui tam* cases brought pursuant to the False Claims Act. We have accrued $3.0 million related to ongoing settlement discussions relating to *qui tam* claims.

On April 1, 1999, a plaintiff relator filed a lawsuit under the False Claims Act captioned *United States ex rel. Mathews v. Alexandria Rehabilitation Hospital*, CV-99-0604, in the United States District Court for the Western District of Louisiana. On February 29, 2000, the United States elected not to intervene in the lawsuit. The complaint alleged, among other things, that we filed fraudulent reimbursement claims under the Medicare program on a nationwide basis. The district court dismissed the False Claims Act allegations of two successive

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amended complaints. However, the district court s dismissal of the third amended complaint with prejudice was partially reversed by the United States Court of Appeals for the Fifth Circuit on October 22, 2002. The case was remanded to the district court, and our subsequent motion to dismiss was denied on February 21, 2004. The case is currently in the discovery stage on False Claims Act allegations concerning one HealthSouth facility during a specific timeframe. A trial date of October 9, 2007 has been set in the case. We intend to vigorously defend ourselves against the claims alleged by the plaintiff relator. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case.

General Medicine, Meadowbrook, and Greystone Ventures Actions

Pursuant to a Plan and Agreement of Merger dated February 17, 1997, Horizon/CMS Healthcare Corporation (Horizon/CMS) became a wholly owned subsidiary of HealthSouth. At the time of the merger, there was a lawsuit pending against Horizon/CMS in the United States District Court for the Eastern District of Michigan captioned *General Medicine, P.C. v. Horizon/CMS Healthcare Corporation*, CV-96-72624 (the Michigan Action). The complaint alleged that Horizon/CMS wrongfully terminated a contract with General Medicine, P.C. (General Medicine) for the provision of medical directorship services to long-term care facilities owned and/or operated by Horizon/CMS. Effective December 31, 2001, we sold all of our stock in Horizon/CMS to Meadowbrook Healthcare Corporation (Meadowbrook) pursuant to a Stock Purchase Agreement containing disclosure regarding the Michigan Action under which Meadowbrook agreed to indemnify us against losses arising out of the historic and ongoing operations of Horizon/CMS.

Meadowbrook, Horizon/CMS, and General Medicine entered into an agreement to settle the Michigan Action, pursuant to which Horizon/CMS consented to the entry of a final judgment in the amount of $376 million in favor of General Medicine on May 3, 2004 (the Consent Judgment). The settlement agreement provides that, with the exception of $0.3 million paid by Meadowbrook, the Consent Judgment may only be collected from us. At the time of the Consent Judgment, we had no ownership or other interest in Horizon/CMS.

On August 16, 2004, General Medicine filed a lawsuit against us captioned *General Medicine, P.C. v. HealthSouth Corp.*, CV-04-958, in the Circuit Court of Shelby County, Alabama, seeking to recover the unpaid amount of the Consent Judgment. The complaint alleges that while Horizon/CMS was a wholly owned subsidiary of HealthSouth and General Medicine was an existing creditor of Horizon/CMS, we caused Horizon/CMS to transfer assets to us thereby rendering Horizon/CMS insolvent and unable to pay its creditors. The complaint asserts that these transfers were made for less than a reasonably equivalent value and/or with the actual intent to defraud creditors of Horizon/CMS, including General Medicine, in violation of the Alabama Uniform Fraudulent Transfer Act. General Medicine s complaint requests relief including recovery of the unpaid amount of the Consent Judgment, the avoidance of the subject transfers of assets, attachment of the assets transferred to us, appointment of a receiver over the transferred properties, and a monetary judgment for the value of properties transferred. We filed an answer denying liability to General Medicine, and on February 28, 2005, the General Medicine case was transferred to the Circuit Court of Jefferson County, Alabama, and assigned case number CV-05-1483.

On October 6, 2004, Meadowbrook filed a declaratory judgment action against us in the Circuit Court of Shelby County, Alabama, captioned *Meadowbrook Healthcare Corporation v. HealthSouth Corp*., CV-04-1131, seeking a declaration that it is not contractually obligated to indemnify us against General Medicine s complaint. This case was transferred to the Circuit Court of Jefferson County, Alabama on May 9, 2005, and assigned case number CV-05-3042. On July 26, 2005, we filed an Answer and Verified Counterclaim for Injunctive and Other Relief seeking a judgment requiring Meadowbrook to indemnify us against the claims asserted by General Medicine in its complaint and other relief based upon legal and equitable theories. In August of 2005, both

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parties to the Meadowbrook case filed motions for summary judgment based upon the express language of the indemnification provision in the Stock Purchase Agreement. On November 15, 2005, the court entered a final order determining that Meadowbrook is not obligated under the Stock Purchase Agreement to indemnify us against the claims asserted by General Medicine in its complaint. The final order did not adjudicate our equitable claims against Meadowbrook which, if successful, would require Meadowbrook to pay our liability, if any, to General Medicine. On December 21, 2005, we filed an appeal of the court s ruling that Meadowbrook has no contractual obligation to indemnify us under the Stock Purchase Agreement, captioned *HealthSouth Corporation vs. Meadowbrook Healthcare, Inc*., appeal no. 1050406, in the Supreme Court of Alabama.

On December 9, 2005, we filed a First Amended Counterclaim asserting counterclaims against Meadowbrook, General Medicine and Horizon/CMS for fraud, injurious falsehood, tortious interference with business relations, bad faith, conspiracy, unjust enrichment, and other causes of action. The First Amended Counterclaim alleges that the Consent Judgment is the product of fraud, collusion and bad faith by Meadowbrook, General Medicine, and Horizon/CMS and, further, that these parties are guilty of a conspiracy to manufacture a lawsuit against HealthSouth in favor of General Medicine and to divert the assets of Horizon/CMS to Meadowbrook and away from creditors, including HealthSouth. The Meadowbrook case and the General Medicine cases were consolidated for purposes of discovery and pre-trial matters on January 26, 2006.

On January 3, 2006, we filed a motion for summary judgment challenging General Medicine s standing under the Alabama Uniform Fraudulent Transfer Act to bring this action against us to collect monies allegedly owed by Horizon/CMS. Specifically, we argued in our motion for summary judgment that General Medicine is no longer a creditor of Horizon/CMS due to General Medicine s settlement with Horizon/CMS and Meadowbrook s payment of $0.3 million to General Medicine on Horizon/CMS s behalf. On May 11, 2006, the court entered an order denying our motion for summary judgment. On June 22, 2006, we filed a petition for writ of mandamus with the Supreme Court of Alabama, requesting a reversal of the court s order denying our motion for summary judgment, captioned *Ex Parte HealthSouth Corporation*, appeal no. 1051366. On July 19, 2006, the Alabama Supreme Court issued an order staying all proceedings in this case pending the disposition of our petition for writ of mandamus.

After our sale of all of our stock in Horizon/CMS to Meadowbrook Healthcare, Inc., Meadowbrook changed its name to Greystone Ventures, Inc. (Greystone). On June 8, 2006, Greystone and Horizon/CMS filed a lawsuit against us in the Circuit Court of Jefferson County, Alabama captioned *Greystone Ventures, Inc., et al v. HealthSouth Corporation*, CV-2006-03403. The complaint alleges that that we received a settlement from Gulf Insurance Company in June of 2004 in the approximate amount of $4 million dollars, and that some or all of the proceeds of that settlement belong to Horizon/CMS and Greystone. The complaint further alleges that we are liable to Horizon/CMS and Greystone for conversion, fraudulent failure to disclose, money had and received, unjust enrichment, negligence and wantonness in connection with our alleged failure to pay the proceeds of the Gulf Insurance Company settlement to Greystone and Horizon/CMS. We filed an answer on July 17, 2006 denying that we have any liability to Greystone or Horizon/CMS with regard to allegations made in their complaint.

We intend to vigorously defend ourselves against the claims alleged by the plaintiffs in the above captioned actions. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of these cases.

Massachusetts Real Estate Actions

On February 3, 2003, HRPT Properties Trust (HRPT) filed a lawsuit against Senior Residential Care/North Andover, Limited Partnership (SRC) in the Land Court for the Commonwealth of Massachusetts

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captioned *HRPT Properties Trust* v. *Senior Residential Care/North Andover, Limited Partnership*, Misc. Case No. 287313, in which it claimed an ownership interest in certain parcels of real estate in North Andover, Massachusetts and alleged that SRC unlawfully occupied and made use of those properties. On March 17, 2003, we (and our subsidiary, Greenery Securities Corp.) moved to intervene in this case to claim ownership of the disputed property pursuant to an agreement that involved the conveyance of five nursing homes and to effect a transfer of title to the disputed property by HRPT to us or our nominee.

On April 16, 2003, Senior Housing Properties Trust (SNH) and its wholly owned subsidiary, HRES1 Properties Trust (HRES1), filed a lawsuit against us in Land Court for the Commonwealth of Massachusetts captioned *Senior Housing Properties Trust and HRES1 Properties Trust v. HealthSouth Corporation,* Misc. Case No. 289182, seeking reformation of a lease pursuant to which we, through subsidiaries, operate the Braintree Rehabilitation Hospital in Braintree, Massachusetts and the New England Rehabilitation Hospital in Woburn, Massachusetts. HRES1 and SNH allege that certain of our representatives made false statements regarding our financial position, thereby inducing HRES1 to enter into lease terms and other arrangements to which it would not have otherwise agreed. HRES1 and SNH have since amended their complaint to add claims for rescission and damages for fraud. HRES1 and SNH seek to reform the lease to increase the annual rent from $8.7 million to $10.3 million, to increase the repurchase option price at the end of the lease term to $80.3 million from $40 million, and to change the lease term to expire on January 1, 2006 instead of December 31, 2011. We filed an answer to the complaint and amended complaint denying the allegations, and we asserted claims against HRPT and counterclaims against SNH and HRES1 for breach of contract, reformation, and fraud based on the failure to convey title to the property in North Andover. We also seek damages incurred as a result of that failure to convey. The two actions in the Land Court have been consolidated for all purposes.

On May 13, 2005, the Land Court ruled that we are entitled to a jury trial in the consolidated cases. SNH, HRES1, and HRPT took interlocutory appeal from this order to the Massachusetts Supreme Judicial Court, during which time the consolidated Land Court cases were stayed. The Supreme Judicial Court ruled on July 17, 2006 that HealthSouth was not entitled to a jury trial. On July 27, 2006, the Land Court convened a status conference and lifted the stay of proceedings. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of the consolidated Land Court cases.

In a related action, on November 2, 2004, we filed a lawsuit in the Commonwealth of Massachusetts, Middlesex County Superior Court, captioned *HealthSouth Corporation v. HRES1 Properties Trust*, Case No. 04-4345, in response to our receipt of a notice from HRES1 purporting to terminate our lease governing the Braintree Rehabilitation Hospital in Braintree, Massachusetts and the New England Rehabilitation Hospital in Woburn, Massachusetts due to our alleged failure to furnish quarterly and annual financial information pursuant to the terms of the lease. In the lawsuit, we seek a declaration that we are not in default of our obligations under the lease, as well as an injunction preventing HRES1 from terminating the lease, taking possession of the property on which the hospitals and facilities are located, and assuming or acquiring the hospital businesses and any licenses related thereto. We filed an amended complaint asserting violations of the Massachusetts unfair and deceptive business practices statute and adding HRPT as a party. On November 8, 2004, HRES1 and SNH, its parent, filed a counterclaim seeking a declaration that it lawfully terminated the lease and an order requiring us to use our best efforts to transfer the licenses for the hospitals and to continue to manage the hospitals during the time necessary to effect such transfer.

On September 25, 2005, the Superior Court granted HRPT s motion to dismiss and granted SNH and HRES1 s motion for summary judgment on our requests for declaratory and injunctive relief, ruling that their termination of the lease was valid. On September 29, 2005, the court, at SNH and HRES1 s request, appointed a receiver to hold the net cash proceeds of operations of the facilities during the pendency of the litigation.

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Following a bench trial regarding issues relating to the parties relationship post-termination, the court entered a judgment dated January 18, 2006 requiring us to use our best efforts to accomplish the license transfer while managing the facilities for HRES1 s account and to pay HRES1 the net cash proceeds of the hospitals after deducting direct operating expenses and a management fee equal to 5% of net patient revenues for the period from October 26, 2004 through the date that a successor operator assumes control over the facilities. Accordingly, we are cooperating with HRES1 regarding the transfer of the licenses. Certain affiliates of Five Star Quality Care, Inc., as HRES1 s proposed successor operators for the hospitals, have not yet obtained regulatory approvals from the Massachusetts Department of Public Health.

On January 24, 2006, we filed the first of three Notices of Appeal addressing entry of judgment and all orders encompassed therein, including the order granting SNH and HRES1 s motion for summary judgment on the lease termination issue and their request for the appointment of a receiver. A hearing on the appeal has not yet been scheduled. On January 31, 2006, the Superior Court denied our request to stay the judgment during the appeal, and, on February 2, 2006, a Single Justice of the Appeals Court also denied our request for a stay. Since the first Notice of Appeal was filed, we filed two additional Notices of Appeal addressing the denial of certain post-judgment motions filed by HealthSouth, including motions to modify the judgment. Our appeal was docketed in the Massachusetts Appeals Court on July 27, 2006. The parties have not yet briefed the arguments on appeal.

SNH, HRES1, and HRPT filed post-trial motions seeking to require HealthSouth to pay their attorneys fees and costs incurred in the Superior Court litigation. The amount at issue is approximately $1.4 million. We have opposed these motions. A hearing on these motions was scheduled for July 17, 2006 and has been postponed. No new hearing date has been set.

On April 5, 2006, the Massachusetts Department of Public Health advised SNH and HRES1 that it would not commence its full review of the applications for approvals to operate the hospitals submitted by SNH and HRES1 s prospective new tenants because there was no agreement with HealthSouth setting forth the terms of the proposed transfer of the hospitals as required by applicable regulations. In light of this determination, on April 25, 2006, we served HRES1 with a motion to modify the judgment requiring us to manage the facilities for a fee equal to 5% of net patient revenues. That motion was denied and, as indicated above, the denial is one subject of our appeal.

Through July 15, 2006, we have paid approximately $17.9 million representing the net cash proceeds of the hospitals for the period between October 26, 2004 and June 30, 2006, which includes approximately $10.2 million previously paid to HRES1 as rent during the period from October 26, 2004 through December 31, 2005. Based on the judgment, our results of operations for the three and six months ended June 30, 2006 and 2005 include only a management fee received from our management of the applicable facilities.

We intend to vigorously defend ourselves against the claims alleged in the above captioned actions. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of these cases.

Other Litigation

On September 17, 1998, John Darling, who was one of the federal False Claims Act relators in the now-settled *Devage* case, filed a lawsuit captioned *Darling v. HealthSouth Sports Medicine & Rehabilitation, et al*., 98-6110-CI-20, in the Circuit Court for Pinellas County, Florida. The complaint alleges that Mr. Darling was injured while receiving physical therapy during a 1996 visit to a HealthSouth outpatient rehabilitation facility in Clearwater, Florida. The complaint was amended in December 2004 to add a punitive damages claim. This

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amended complaint alleges that fraudulent misrepresentations and omissions by us resulted in the injury to Mr. Darling. The court ordered the parties to participate in non-binding arbitration which resulted in a finding in our favor on December 27, 2005. The trial date for this case has not been set. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or settlement of this case.

We have been named as a defendant in two lawsuits brought by individuals in the Circuit Court of Jefferson County, Alabama, *Nichols v. HealthSouth Corp.*, CV-03-2023, filed March 28, 2003, and *Hilsman v. Ernst & Young, HealthSouth Corp., et al.*, CV-03-7790, filed December 12, 2003. The plaintiffs allege that we, some of our former officers, and our former auditor engaged in a scheme to overstate and misrepresent our earnings and financial position. The plaintiffs seek compensatory and punitive damages. On March 24, 2003, a lawsuit captioned *Warren v. HealthSouth Corp., et al.*, CV-03-5967, was filed in the Circuit Court of Montgomery County, Alabama. The lawsuit, which claims damages for the defendants alleged negligence, wantonness, fraud and breach of fiduciary duty, was transferred to the Circuit Court of Jefferson County, Alabama. Each of the lawsuits described in this paragraph has been consolidated with the *Tucker* case for discovery and other pretrial purposes.

On December 28, 2004, we commenced a collection action in the Circuit Court of Jefferson County, Alabama, captioned *HealthSouth Medical Center, Inc. v. Neurological Surgery Associates, P.C.,* CV-04-7700, to collect unpaid loans in the original principal amount of approximately $0.3 million made to Neurological Surgery Associates, P.C. (NSA), pursuant to a written Practice Guaranty Agreement. The purpose of the loans was to enable NSA to employ a physician who would bring necessary specialty skills to patients served by both NSA and the acute-care hospital in Birmingham, Alabama we recently sold. NSA has asserted counterclaims that we breached verbal promises to lease space and employees from NSA, to pay NSA for billing and coding services performed by NSA on behalf of the subject physician-employee, and to pay NSA to manage the subject physician-employee. This case is currently in the discovery phase. We intend to vigorously defend ourselves against these counterclaims. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or settlement of this case.

On June 2, 2003, Vanderbilt Health Services, Inc. and Vanderbilt University filed a lawsuit captioned *Vanderbilt Health Services, Inc. and Vanderbilt University v. HealthSouth Corporation*, Case No. 03-1544-III, in the Chancery Court for Davidson County, Tennessee. We are partners with the plaintiffs in a partnership that operates a rehabilitation hospital in Nashville, Tennessee. In the complaint, the plaintiffs allege that we violated the terms of a non-competition provision in the partnership agreement in connection with our purchase of a number of rehabilitation clinics in the Nashville area. Effective as of January 20, 2006, we settled this case and obtained a full and final release of all claims. The settlement did not have a material effect on our financial position, results of operations, or cash flows.

On July 19, 2005, Gary Bellinger filed a *pro se* complaint captioned *Gary Bellinger v. Eric Hanson, d/b/a U.S. Strategies, Inc., Medika Group, Ltd., Laserlife, Inc., & Relife, Inc., and Richard Scrushy, d/b/a HealthSouth*, Case No. 05-06898-B, In the District Court, Dallas County, Texas, 44th Judicial District. Mr. Bellinger claims the defendants violated the terms of a distribution agreement with his company, Laser Bio Therapy, Inc., resulting in that company s bankruptcy. He has sued for breach of contract, breach of fiduciary duty, and fraud, and claims compensatory damages of $270 million and punitive damages of $10 million. On April 12, 2006, the judge entered an order dismissing us from the case without prejudice.

On June 2, 2006, we were named as a defendant in a lawsuit captioned *Brockovich v. HealthSouth Corporation, et al.*, Case No. SACV06-546-DOC(MLGx), filed under the Medicare Secondary Payor statute, 42

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U.S.C. § 1395y(b), in the United States District Court for the Central District of California, Southern Division, against HealthSouth, HealthSouth Hospital Corporation, HCS, Ltd., and certain insurance companies. The complaint alleges that HealthSouth has charged Medicare to treat illnesses that it caused, at least in part, by medical error or neglect and seeks recovery of unspecified damages. HealthSouth s responsive pleading is due August 14, 2006. We intend to vigorously defend ourselves against the claims alleged by the plaintiff. Based on the stage of litigation, and review of the current facts and circumstances, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this case.

Other Matters

The reconstruction of our historical financial records has resulted in the restatement of not only our consolidated financial statements, but also the financial statements of certain of our subsidiary partnerships. The process of communicating the effect of these restatements to the outside partners has begun, and we anticipate the process of resolving the partnership issues arising from these restatements will be predominantly complete by the end of 2006. The ultimate resolution of these matters may have a negative impact on our relationships with our partners, or could cause us to incur charges in future periods.

At this time, we have completed a portfolio-wide review of our partnerships to assess the impact of the restatement adjustments on the financial statements of our subsidiary partnerships. As of June 30, 2006, we have accrued approximately $11.2 million as a liability related to these issues based on the current status of discussions with our partners. These discussions are ongoing, and this estimated liability may change in future periods.

In addition, as it is our obligation as a participant in Medicare and other federal health care programs, we routinely conduct audits and reviews of the accuracy of our billing systems and other regulatory compliance matters. As a result of these reviews, we have made, and will continue to make, disclosures to the Office of the Inspector General of the United States Department of Health and Human Services relating to amounts that we suspect represent over-reimbursements from these programs, whether due to inaccurate billing or otherwise. Some of these disclosures have resulted in, or may result in, the Company refunding amounts to Medicare or other federal health care programs.

12. Segment Reporting:

We define segment operating earnings as income before (1) interest income; (2) interest expense and amortization of debt discounts and fees; (3) gain or loss on early extinguishment of debt; (4) gain or loss on sale of investments; (5) gain or loss on our interest rate swap; and (6) income tax expense or benefit. We also do not allocate corporate overhead to our operating segments. The chief operating decision maker of HealthSouth uses segment operating earnings as an analytical indicator for purposes of allocating resources to a particular segment and assessing segment performance. Revenues and expenses are measured in accordance with the policies and procedures described in Note 1, *Summary of Significant Accounting Policies*, to the consolidated financial statements accompanying our 2005 Form 10-K.

As part of the continued implementation of our strategic plan, management continues to evaluate the role of each segment and the services provided within each segment. Based on this evaluation, in the second quarter of 2006, our management realigned five electro-shock wave lithotripter units from our diagnostic segment to our corporate and other segment, as the services performed by these lithotripter units are not diagnostic services. We also realigned five occupational medicine centers from our corporate and other segment into our outpatient segment, as these centers provide therapy services that are consistent with other services provided by our outpatient segment. Prior periods have been reclassified to conform to this presentation.

HealthSouth Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Selected financial information for our operating segments for each of the three months ended June 30, 2006 and 2005 and the six months ended June 30, 2006 and 2005 is as follows (in thousands):

	Inpatient	Surgery Centers	Outpatient	Diagnostic	Corporate and Other	Total
Three months ended June 30, 2006						
Net operating revenues	$ 451,345	$ 191,261	$ 85,682	$ 51,268	$ 20,424	$ 799,980
Intersegment revenues					12,467	12,467
Operating earnings (loss)	95,517	20,113	7,535	(12,059)	(76,478)	34,628
Total assets	1,480,676	862,252	112,154	122,412	733,243	3,310,737
Three months ended June 30, 2005						
Net operating revenues	$ 459,098	$ 197,985	$ 98,479	$ 56,831	$ 24,272	$ 836,665
Intersegment revenues					18,388	18,388
Operating earnings (loss)	109,603	21,920	5,687	1,024	(98,616)	39,618
Total assets	1,544,358	903,456	133,594	146,505	1,064,725	3,792,638
Six months ended June 30, 2006						
Net operating revenues	$ 899,856	$ 384,213	$ 175,217	$ 104,131	$ 39,976	$ 1,603,393
Intersegment revenues					26,067	26,067
Operating earnings (loss)	194,406	46,557	16,835	(15,081)	(166,517)	76,200
Total assets	1,480,676	862,252	112,154	122,412	733,243	3,310,737
Six months ended June 30, 2005						
Net operating revenues	$ 934,996	$ 403,581	$ 201,170	$ 111,815	$ 48,518	$ 1,700,080
Intersegment revenues					36,908	36,908
Operating earnings (loss)	206,862	52,203	15,165	5,648	(388,131)	(108,253)
Total assets	1,544,358	903,456	133,594	146,505	1,064,725	3,792,638

Segment reconciliations to our condensed consolidated results of operations are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net operating revenues:				
Total segment net operating revenues	$ 799,980	$ 836,665	$ 1,603,393	$ 1,700,080
Elimination of intersegment revenues	(12,467)	(18,388)	(26,067)	(36,908)
Total consolidated net operating revenues	$ 787,513	$ 818,277	$ 1,577,326	$ 1,663,172
Loss from continuing operations:				
Total segment operating earnings (loss)	$ 34,628	$ 39,618	$ 76,200	$ (108,253)
Interest income	4,317	3,516	8,377	6,894
Interest expense and amortization of debt discounts and fees	(82,974)	(84,433)	(168,228)	(170,851)
Gain on interest rate swap	18,604		14,789	
Loss on early extinguishment of debt	(4,565)	(33)	(365,642)	(33)
Gain (loss) on sale of investments	1,049	(4,592)	1,943	(2,941)
Loss from continuing operations before income tax expense	$ (28,941)	$ (45,924)	$ (432,561)	$ (275,184)
Total assets:				
Total assets for reportable segments	$ 3,310,737	$ 3,792,638	$ 3,310,737	$ 3,792,638
Elimination of intersegment assets	(188)	(2,131)	(188)	(2,131)

Total assets	$ 3,310,549	$ 3,790,507	$ 3,310,549	$ 3,790,507

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

The following Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) relates to HealthSouth Corporation and its subsidiaries, and should be read in conjunction with our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this Quarterly Report on Form 10-Q, and our audited consolidated financial statements for the year ended December 31, 2005 and Management s Discussion and Analysis of Results of Operations and Financial Condition which are contained in our Annual Report on Form 10-K for the year ended December 31, 2005 (2005 Form 10-K). As used in this report, the terms HealthSouth, we, our, us, and the company refer to HealthSouth Corporation and its subsidiaries, unless otherwise stated or indicated by context.

This MD&A is designed to provide the reader with information that will assist in understanding our condensed consolidated financial statements, the changes in certain key items in those financial statements from period to period, and the primary factors that accounted for those changes, as well as how certain accounting principles affect our condensed consolidated financial statements. The discussion also provides information about the financial results of the various segments of our business to provide a better understanding of how those segments and their results affect the financial position and results of operations of HealthSouth as a whole.

Executive Overview

HealthSouth is one of the largest providers of ambulatory surgery, rehabilitative health care, and diagnostic imaging services in the United States, with 1,042 facilities and approximately 36,000 full- and part-time employees. We provide these services through a national network of inpatient and outpatient rehabilitation facilities, outpatient surgery centers, diagnostic centers, and other health care facilities.

Our business is currently divided into four primary operating divisions inpatient, surgery centers, outpatient, and diagnostic and a fifth division that manages certain other revenue producing activities and corporate functions. These five divisions correspond to our five reporting segments discussed later in this Item. For the three and six months ended June 30, 2006, our inpatient division comprised approximately 58% of our consolidated *Net operating revenues* and over 80% of our operating earnings from our four primary operating divisions.

Although our business is continuing to generate substantial revenues, and market factors appear to favor our outpatient and post-acute care business model, we still have several immediate internal and external challenges to overcome before we can realize significant improvements in our business, including:

- *Operational Improvements*. We need to continue to improve our operational efficiency, particularly in our surgery centers, outpatient, and diagnostic divisions. This includes streamlining our division management structure, continuing to consolidate or divest underperforming facilities, and implementing standardized performance metrics and practices, while continuing to ensure high quality care. We also will strive to reduce operational variation within each division.

- *Price Pressure*. We are seeing downward pressure on prices in our markets, from both commercial and government payors. We anticipate continuing price pressure in all our divisions. For example, recent changes to the prospective payment system applicable to our inpatient rehabilitation facilities (IRF-PPS) have had a negative impact on inpatient revenues in 2006. In addition, Medicare has frozen ambulatory surgery center (ASC) pricing through 2009, and beginning in 2007, the Deficit Reduction Act of 2005 will cap ASC and imaging service payments at hospital outpatient department reimbursement levels. Other pricing changes may have a negative impact on our operating results.

In addition, CMS recently issued a proposed ASC pricing rule that could have a neutral or positive impact on our surgery centers division s *Net operating revenues* once the new pricing system is in place, depending upon the rule s overall effect on unit pricing and our ability to realize increased case volume as the list of approved ASC procedures is expanded. However, the proposed rule has not been finalized and we cannot provide any assurance that the rule, if finalized in its current form, will have the impact we predict. For additional information, see this Item, Segment Results of Operations Surgery Centers.

Single-Payor Exposure. Medicare comprises approximately 47% of our consolidated *Net operating revenues* and approximately 69% of our largest division s revenues. Consequently, single-payor exposure presents a serious risk. In particular, the combination of volume volatility created by the 75% Rule and lower unit pricing resulting from IRF-PPS changes reduced our operating earnings in the first six months of 2006 and will have a continuing negative impact on our operating earnings.

Competition. Competition is increasing as physicians look for new revenue sources to offset declining incomes. In our outpatient and diagnostic divisions, physician practices that reach sufficient size may elect to insource some or all of their therapy or diagnostic services. In addition, the low barriers to entry in the outpatient physical therapy sector and decreasing barriers to entry in the diagnostic sector make competition from physician practices a factor to be considered in those markets.

Declining Ownership Share of Surgery Centers. Like most other ASCs, the majority of our centers are owned in partnership with surgeons and other physicians who perform procedures at the centers. As a result of increased competition in the ASC market and other factors, physicians are demanding increased equity participation in ASCs. Consequently, we expect to see our percentage ownership of centers within our ASC portfolio decline over time.

Leverage. Although we have completed a series of recapitalization transactions that have eliminated significant uncertainty regarding our capital structure and have improved our financial position, we remain highly leveraged. Our high leverage increases our cost of capital, decreases our net income, and may prevent us from taking advantage of potential growth opportunities.

Settlement Costs. We have significant cash obligations we must meet in the near future as a result of recent settlements with various federal agencies. Specifically, we are required to pay the remaining balance of our $325 million settlement to the United States in quarterly installments ending in the fourth quarter of 2007 to satisfy our obligations under a settlement described in Item 1, *Business*, Medicare Program Settlement, of our 2005 Form 10-K. Furthermore, we are required to pay the remaining balance of our $100 million settlement to the United States Securities and Exchange Commission (the SEC) in four installments ending in the fourth quarter of 2007, as described in Item 1, *Business*, SEC Settlement, of our 2005 Form 10-K. Payments due under these settlement agreements are as follows as of June 30, 2006:

	Medicare Program Settlement	**SEC Settlement**	**Total**
		(In Thousands)	
July 1 through December 31, 2006	$ 42,053	$ 25,000	$ 67,053
2007	86,666	50,000	136,666
	$ 128,719	$ 75,000	$ 203,719

Continuing Investigations and Litigation. While we have reached a non-prosecution agreement with the United States Department of Justice (the DOJ) and have settled much of the government s litigation against us, we face continuing government investigations, as well as numerous class action and individual lawsuits, all of which will continue to consume considerable management attention and company resources and could result in substantial additional payments and fines. For additional information, see Note 10, *Settlements*, to the condensed consolidated financial statements contained in Part I, Item 1 of this report. In addition, although we have reached a global, preliminary agreement in principle with the lead plaintiffs in the federal securities class actions and the derivative litigation, as well as with our insurance carriers, to settle claims filed against us, certain of our former directors and officers, and certain other parties, there can be no assurance that a final settlement can be reached or that the proposed settlement will receive the required court approval. For additional information, see Item 1, *Business*, Securities Litigation Settlement, of our 2005 Form 10-K.

Reconstruction, Restatement, and Sarbanes-Oxley Related Costs. We paid approximately $208 million in 2005 in connection with the restructuring of our financial reporting processes, internal control over

financial reporting, and managerial operations, and the reconstruction and/or restatement of our consolidated financial statements for the years ended December 31, 2004, 2003, 2002, 2001, and 2000. We anticipate incurring additional related costs in the future, although we expect these costs to decline over time. For the three months ended June 30, 2006 and 2005, we paid approximately $42 million and $57 million, respectively, for such costs. These costs for the six months ended June 30, 2006 and 2005 approximated $97 million and $114 million, respectively.

While we expect our 2006 operating results will be consistent with the fact that we are still in a turnaround period, we are optimistic about the long-term positioning of HealthSouth. We continue to offer high quality services in growing segments of the health care industry which should provide long-term growth opportunities. In addition, we are stabilizing operations in our three ambulatory divisions (surgery centers, outpatient, and diagnostic) by focusing on volume growth, expense control through benchmarking and supply chain management, and standardization of our billing and collecting procedures. We are also looking to grow in targeted areas as development and consolidation opportunities arise. We believe we will see the results of these initiatives in late 2006 and in subsequent years.

Consolidated Results of Operations

During the three and six months ended June 30, 2006 and 2005, we derived consolidated *Net operating revenues* from the following payor sources:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Medicare	46.5%	47.3%	46.7%	47.2%
Medicaid	2.3%	2.3%	2.3%	2.3%
Workers compensation	7.0%	7.5%	7.1%	7.6%
Managed care and other discount plans	34.9%	32.5%	34.3%	32.4%
Other third-party payors	5.1%	5.8%	5.2%	6.0%
Patients	1.5%	2.1%	1.6%	2.0%
Other income	2.7%	2.5%	2.8%	2.5%
Total	100.0%	100.0%	100.0%	100.0%

When reading our condensed consolidated statements of operations, it is important to recognize the following items included within our results of operations:

Stock-Based Compensation. During the three and six months ended June 30, 2006, stock-based compensation increased by approximately $3.1 million and $7.2 million, respectively, due to our adoption of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, on January 1, 2006 and the timing of stock awards in 2005 and the first quarter of 2006. These increased costs are included in *Salaries and benefits* in our condensed consolidated statements of operations and comprehensive loss.

Restructuring charges. In our continuing efforts to streamline operations, we closed underperforming facilities or consolidated similar facilities within the same market in the three and six months ended June 30, 2006 and 2005. As a result of these facility closures or consolidations, we recorded certain restructuring charges approximating $2.1 million and $5.6 million in the three months ended June 30, 2006 and 2005, respectively, and $3.2 million and $7.2 million for the six months ended June 30, 2006 and 2005, respectively, for one-time termination benefits, contract termination costs, and other associated costs under the guidance in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

Changes in ownership of certain inpatient rehabilitation facilities. As noted in Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations*, of our 2005 Form 10-K and

Note 11, *Contingencies*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report, we have been involved in a legal dispute regarding the lease of Braintree Rehabilitation Hospital in Braintree, Massachusetts and New England Rehabilitation Hospital in Woburn, Massachusetts since 2003. In 2005, a judgment was entered against us that upheld the landlord s termination of our lease of these two facilities and placed us as the manager, rather than the owner, of these two facilities. We have appealed this decision. Our 2005 and 2006 results of operations include only the management fees we earned for operating the facilities on behalf of the landlord during these periods.

As discussed in our comprehensive Annual Report on Form 10-K for the years ended December 31, 2003 and 2002, the Braintree and Woburn facilities were part of a larger transaction associated with a former HealthSouth acquisition. As part of our acquisition of Horizon/CMS HealthCare Corporation, we acquired a group of nursing home facilities, which were subsequently sold to Integrated Health Services, Inc. (IHS). IHS assumed the original leases relating to the acquired facilities, but the property owner agreed to consent to the assignment of the original leases to IHS and release HealthSouth from its guarantee, effective only when and if IHS obtained its own license to operate these facilities (known as the Greenery facilities). To complete the sale, HealthSouth and IHS entered into a separate agreement that allowed IHS to essentially operate the nursing homes under the HealthSouth license, but IHS was required to use its best efforts to obtain its own license. As IHS never obtained its own license, the property owner never released HealthSouth from its lease obligation.

In February 2000, IHS filed for bankruptcy and shortly thereafter, HealthSouth resumed operations of the Greenery facilities. These facilities continued to experience operating losses and were closed in late 2001. At that time, we owed approximately $42 million on the existing lease agreement, and we recognized a liability for that amount in our 2001 consolidated financial statements.

To settle the original lease, we entered into a sale-leaseback transaction with the landlord for the Braintree and Woburn facilities in exchange for termination of the lease on the Greenery facilities. Under the settlement agreement, we leased the Braintree and Woburn facilities under new lease agreements, canceling the existing lease agreement. The new lease was for a period of ten years with rent obligations of approximately $8.7 million per year. However, the new lease agreements not only included the negotiated rent on the Braintree and Woburn facilities, but also included payments that, in effect, represented the rent payable under the original lease on the Greenery facilities.

We accounted for the rent on the Braintree and Woburn facilities as rent expense in our inpatient segment. However, the rent expense paid above the negotiated rent for these facilities was recorded as an obligation of our corporate and other segment. As a result of the lease termination associated with the Braintree and Woburn facilities, our corporate and other segment recorded a $30.5 million net gain on lease termination during the six months ended June 30, 2005. This net gain is included in *Other operating expenses* in our condensed consolidated statement of operations and comprehensive loss and represents the difference between the $42 million liability recorded in 2001 and the remaining liability on the date the judgment was entered against us in 2005.

Impairments. During the three and six months ended June 30, 2006, we recorded impairment charges totaling approximately $3.9 million to reduce the carrying value of long-lived assets and certain amortizable intangibles to their estimated fair market value. During the three months ended June 30, 2005, we recorded impairment charges of approximately $13.0 million to reduce the carrying value of property and equipment to its estimated fair market value. During the six months ended June 30, 2005, total impairment charges related to reducing the carrying value of property and equipment to its estimated fair market value approximated $24.9 million.

Government, class action, and related settlements expense. Our *Net loss* for the three and six months ended June 30, 2006 includes a $3.0 million charge in *Government, class action, and related settlements expense* related to a payment made to the U.S. Postal Inspection Services Consumer Fraud Fund in connection with the execution of the non-prosecution agreement reached with the DOJ. For additional information related to the non-prosecution agreement, see Note 10, *Settlements*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of

this report. *Government, class action, and related settlements expense* for the three and six months ended June 30, 2006 also includes charges of approximately $11.2 million, the majority of which will not require a cash outflow, related to ongoing settlement discussions with our subsidiary partnerships related to the restatement of their historical financial statements, and $3.0 million related to ongoing settlement discussions relating to *qui tam* claims. For additional information regarding these ongoing discussions, see Note 11, *Contingencies*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Our *Net loss* for the six months ended June 30, 2005 includes a $215.0 million charge as *Government, class action, and related settlements expense* under a global, preliminary agreement in principle with the lead plaintiffs in the federal securities class actions and the derivative litigation, as well as with our insurance carriers, to settle claims filed against us, certain of our former directors and officers, and certain other parties. For additional information, see Note 10, *Settlements*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Professional fees accounting, tax, and legal. As noted throughout our 2005 Form 10-K, significant changes have occurred at HealthSouth since the events leading up to March 19, 2003. The steps taken to stabilize our business and operations, provide vital management assistance, and coordinate our legal strategy came at significant financial cost. During the three months ended June 30, 2006, *Professional fees accounting, tax, and legal* approximated $28.0 million and related primarily to professional services to support the preparation of our Form 10-Q for the first quarter of 2006 (including the preparation of quarterly information for 2005, which had never been presented), tax preparation and consulting fees related to various tax projects, and legal fees for continued litigation defense and support for matters discussed in Note 11, *Contingencies*, to our condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report. During the six months ended June 30, 2006, *Professional fees accounting, tax, and legal* approximated $76.6 million and related primarily to the preparation of our 2005 Form 10-K, as well as those professional services discussed above. During the three and six months ended June 30, 2005, these fees approximated $29.0 million and $80.4 million, respectively, and primarily related to the preparation of our comprehensive Form 10-K for the years ended December 31, 2003 and 2002, including the restatement of our previously issued 2001 and 2000 consolidated financial statements.

Loss on early extinguishment of debt. On June 14, 2006, we completed a private offering of $1.0 billion aggregate principal amount of senior notes, the proceeds of which, together with cash on hand, were used to repay all borrowings outstanding under our Interim Loan Agreement (as defined in our 2005 Form 10-K). As a result of this transaction, we recorded an approximate $4.1 million *Loss on early extinguishment of debt* during the second quarter of 2006. The remainder of our *Loss on early extinguishment of debt* for the three months ended June 30, 2006 was due to the repayment of certain bonds payable during the quarter.

On March 10, 2006, we completed the last of a series of recapitalization transactions enabling us to prepay substantially all of our prior indebtedness and replace it with approximately $3 billion of new long-term debt. As a result of these transactions, our *Loss on early extinguishment of debt* for the six months ended June 30, 2006 includes a charge of approximately $361.1 million.

For more information regarding these transactions, see Note 4, *Long-term Debt*, to our accompanying condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Gain on interest rate swap. As discussed in more detail in Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report, we entered into an interest rate swap in March 2006 to effectively convert a portion of our variable rate debt to a fixed interest rate. During the three and six months ended June 30, 2006, we recorded a net gain of approximately $18.6 million and $14.8 million, respectively, related to the mark-to-market adjustments, quarterly settlements, and accrued interest recorded for the swap.

Reclassifications. Certain financial results have been reclassified to conform to the current period presentation. Such reclassifications primarily relate to facilities we closed or sold in the three months ended June 30, 2006 that qualify under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to be reported as discontinued operations.

For the three months and six months ended June 30, 2006 and 2005, our consolidated results of operations were as follows:

	Three Months Ended June 30,		Percentage Change	Six Months Ended June 30,		Percentage Change
	2006	2005	2006 vs. 2005	2006	2005	2006 vs. 2005
	(In Thousands)			(In Thousands)		
Net operating revenues	$ 787,513	$ 818,277	(3.8%)	$ 1,577,326	$ 1,663,172	(5.2%)
Operating expenses:						
Salaries and benefits	354,870	360,371	(1.5%)	717,596	725,445	(1.1%)
Professional and medical director fees	19,978	23,073	(13.4%)	41,327	39,464	4.7%
Supplies	73,631	79,485	(7.4%)	148,847	157,212	(5.3%)
Other operating expenses	168,442	194,292	(13.3%)	322,166	341,118	(5.6%)
Provision for doubtful accounts	29,592	22,836	29.6%	52,585	46,321	13.5%
Depreciation and amortization	38,917	40,199	(3.2%)	75,851	89,038	(14.8%)
Loss (gain) on disposal of assets	2,954	(2,247)	(231.5%)	(2,105)	12,305	(117.1%)
Impairments	3,860	12,978	(70.3%)	3,860	24,915	(84.5%)
Government, class action, and related settlements expense	17,186		N/A	17,313	215,000	(91.9%)
Professional fees accounting, tax, and legal	27,996	28,981	(3.4%)	76,632	80,370	(4.7%)
Total operating expenses	737,426	759,968	(3.0%)	1,454,072	1,731,188	(16.0%)
Loss on early extinguishment of debt	4,565	33	N/A	365,642	33	N/A
Interest expense and amortization of debt discounts and fees	82,974	84,433	(1.7%)	168,228	170,851	(1.5%)
Interest income	(4,317)	(3,516)	22.8%	(8,377)	(6,894)	21.5%
(Gain) loss on sale of investments	(1,049)	4,592	(122.8%)	(1,943)	2,941	(166.1%)
Gain on interest rate swap	(18,604)		N/A	(14,789)		N/A
Equity in net income of nonconsolidated affiliates	(5,618)	(5,875)	(4.4%)	(10,163)	(16,820)	(39.6%)
Minority interests in earnings of consolidated affiliates	21,077	24,566	(14.2%)	57,217	57,057	0.3%
Loss from continuing operations before income tax expense	(28,941)	(45,924)	(37.0%)	(432,561)	(275,184)	57.2%
Provision for income tax expense	9,086	9,540	(4.8%)	27,019	20,418	32.3%
Loss from continuing operations	(38,027)	(55,464)	(31.4%)	(459,580)	(295,602)	55.5%
Loss from discontinued operations, net of income tax expense	(4,409)	(6,949)	(36.6%)	(17,994)	(25,015)	(28.1%)
Net loss	$ (42,436)	$ (62,413)	(32.0%)	$ (477,574)	$ (320,617)	49.0%

Operating Expenses as a % of Net Operating Revenues

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Salaries and benefits	45.1%	44.0%	45.5%	43.6%
Professional and medical director fees	2.5%	2.8%	2.6%	2.4%
Supplies	9.3%	9.7%	9.4%	9.5%
Other operating expenses	21.4%	23.7%	20.4%	20.5%
Provision for doubtful accounts	3.8%	2.8%	3.3%	2.8%
Depreciation and amortization	4.9%	4.9%	4.8%	5.4%
Loss (gain) on disposal of assets	0.4%	(0.3%)	(0.1%)	0.7%
Impairments	0.5%	1.6%	0.2%	1.5%
Government, class action, and related settlements expense	2.2%	0.0%	1.1%	12.9%
Professional fees accounting, tax, and legal	3.6%	3.5%	4.9%	4.8%
Total operating expenses as a % of net operating revenues	93.6%	92.9%	92.2%	104.1%

Net Operating Revenues

Our consolidated *Net operating revenues* primarily include revenues derived from patient care services provided by one of our four primary operating segments. *Net operating revenues* also include other revenues generated from management and administrative fees, trainer income, operation of the conference center located on our corporate campus, and other non-patient care services.

Volume decreases in our operating segments was the primary factor that contributed to the declining *Net operating revenues* for the three and six months ended June 30, 2006 compared to the same periods of 2005. Our inpatient segment reduced its non-compliant case volumes (i.e., cases involving diagnoses not included on the list of 13 qualifying medical conditions under the 75% Rule) due to the continued phase-in of the 75% Rule. Surgery centers that became equity method investments rather than consolidated entities after the second quarter of 2005, facility closures that did not qualify as discontinued operations, and market competition negatively impacted volumes in our surgery centers segment. Competition from physician-owned similar sites, the nationwide physical therapist shortage, closure of underperforming facilities, and the annual per beneficiary limitations on Medicare outpatient therapy services that became effective January 1, 2006 continued to negatively impact volumes in our outpatient segment. Competition from physician-owned diagnostic centers and the closure of underperforming facilities that did not qualify as discontinued operations continued to negatively impact volumes in our diagnostic segment.

Our inpatient segment was also negatively impacted by certain regulatory pricing changes implemented as of October 1, 2005. We were able to partially mitigate the negative impact of these pricing changes due to an increase in patient acuity. In our other operating segments, we were able to partially offset the negative impact of declining volumes through improvement in net revenue per visit or scan. The change in *Net operating revenues* by segment is discussed in more detail in this Item, Segment Results of Operations.

Salaries and Benefits

Salaries and benefits represent the most significant cost to us and include all amounts paid to full- and part-time employees, including all related costs of benefits provided to employees. It also includes amounts paid for contract labor.

While *Salaries and benefits* decreased by 1.5% and 1.1% for the three and six months ended June 30, 2006, respectively, compared to the same periods of 2005, *Salaries and benefits* as a percent of *Net operating revenues*

increased. This is based primarily on two factors. First, shortages of therapists and nurses have caused us to raise salaries to retain current employees and to increase our utilization of higher-priced contract labor to properly care for our patients. Second, as a result of our efforts to comply with the 75% Rule, we are increasingly treating higher acuity (i.e., sicker) patients, which has resulted in increased labor costs in our inpatient segment. These increased labor costs resulting from higher salaries, greater reliance on contract labor and higher case-mix acuity, along with routine inflationary increases, are occurring in a flat or declining unit pricing environment. In addition, as noted earlier in this Item, stock-based compensation increased by approximately $3.1 million and $7.2 million during the three and six months ended June 30, 2006, respectively, due to our adoption of FASB Statement No. 123(R) on January 1, 2006 and the timing of stock awards in 2005 and the first quarter of 2006. As a result of these factors, *Salaries and benefits* increased as a percent of *Net operating revenues* in each period.

Professional and Medical Director Fees

Professional and medical director fees include professional consulting fees associated with operational initiatives, such as strategic planning and process standardization of billing and collecting procedures. It also includes fees paid under contracts with radiologists, medical directors, and other clinical professionals at our centers for services provided.

The decrease in *Professional and medical director fees* for the three months ended June 30, 2006 compared to the same period of 2005 is due primarily to a decrease in consulting fees for strategic planning and other projects within our corporate and other segment. The increase in *Professional and medical director fees* for the six months ended June 30, 2006 compared to the same period of 2005 is due primarily to increased professional fees in our inpatient segment due to fees paid to a consulting firm for process standardization of billing and collecting procedures and assistance with technology enhancements with installation of upgraded patient accounting systems.

Supplies

Supplies include costs associated with supplies used while providing patient care at our facilities. Examples include pharmaceuticals, implants, bandages, food, and other similar items. For each period presented, our inpatient and surgery centers segments comprise over 93% of our *Supplies* expense.

Supplies expense in the three and six months ended June 30, 2006 decreased when compared to the same periods in 2005 due primarily to the decline in volumes in our inpatient and surgery centers segments.

Other Operating Expenses

Other operating expenses include costs associated with managing and maintaining our operating facilities as well as the general and administrative costs related to the operation of our corporate office. These expenses include such items as repairs and maintenance, utilities, contract services, rent, professional fees, and insurance.

Other operating expenses were lower in the three months ended June 30, 2006 compared to the same period of 2005 due to declining volumes in our inpatient segment, facility closures throughout 2005 in our outpatient segment, and decreased professional fees associated with projects related to our compliance with the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and other similar services from accounting and consulting firms. In addition, as discussed in more detail in Note 3, *Investment in and Advances to Nonconsolidated Affiliates*, to our accompanying condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, of this report, *Other operating expenses* for the three months ended June 30, 2006 also include a $6.9 million gain related to the repayment of a formerly fully reserved note receivable from Source Medical.

Other operating expenses were lower for the six months ended June 30, 2006 compared to the same period of 2005 due primarily to the reasons discussed above. As discussed in more detail in Note 3, *Investment in and*

Advances to Nonconsolidated Affiliates, to our accompanying condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, *Other operating expenses* for the six months ended June 30, 2006 also include a $6.0 million gain related to the elimination of our former guarantee of a promissory note for Source Medical. *Other operating expenses* for the six months ended June 30, 2005 also include the net gain on lease termination recorded during the first quarter of 2005 related to the Greenery facilities, as discussed earlier in this item.

Provision for Doubtful Accounts

For the three months ended June 30, 2006, our *Provision for doubtful accounts* increased as a percent of *Net operating revenues* due primarily to a reassessment of current collection activities and payment trends in our inpatient segment. The installation of new collections software within our inpatient segment negatively impacted collection activity during the second quarter of 2006, but we believe this distraction and negative impact will be temporary. For the six months ended June 30, 2006, our *Provision for doubtful accounts* was higher as a percent of *Net operating revenues* when compared to the same period of 2005 due primarily to a reassessment of our *Refunds due patients and other third-party payors* liability during the first quarter of 2005, as discussed in more detail in this Item, Segment Results of Operations Diagnostic.

Depreciation and Amortization

The decreases in *Depreciation and amortization* during the three and six months ended June 30, 2006 over the comparable periods in 2005 are due to impairment charges in 2005 that decreased the depreciable base of our assets and an increase in fully depreciated assets within our operating segments.

Loss (Gain) on Disposal of Assets

The net gain or loss on asset disposals in each period resulted from various asset sales and disposals primarily in our inpatient, surgery centers, and diagnostic segments. The $12.3 million net loss for the six months ended June 30, 2005 primarily resulted from asset disposals at inpatient rehabilitation facilities in Florida and Arizona.

Interest Expense and Amortization of Debt Discounts and Fees

The decrease in *Interest expense and amortization of debt discounts and fees* for the three and six months ended June 30, 2006 was the result of increased interest expense offset by lower amortization charges.

Due to the recapitalization transactions and the private offering of senior notes described in Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report, the average interest rate for the three and six months ended June 30, 2006, using a rolling twelve-month period, approximated 9.2% compared to an average interest rate of 8.6% for the same periods of 2005. This increase in average interest rates contributed to an approximate $5.2 million and $9.0 million of increased interest expense during the three and six months ended June 30, 2006, respectively. The impact of the increase in average interest rates was offset by lower average borrowings, which decreased interest expense by approximately $2.0 million and $3.9 million during the three and six months ended June 30, 2006, respectively.

Amortization of debt discounts and fees was approximately $4.7 million and $7.7 million less during the three and six months ended June 30, 2006, respectively, compared to the same periods of 2005. The amortization for the three and six months ended June 30, 2005 includes the amortization related to our 6.875% Senior Notes that were repaid in June 2005.

Equity in Net Income of Nonconsolidated Affiliates

The decrease in *Equity in net income of nonconsolidated affiliates* for the six months ended June 30, 2006 compared to the same period of 2005 is due to the recovery of approximately $6.9 million of equity losses during the first quarter of 2005.

Minority Interests in Earnings of Consolidated Affiliates

Minority interests in earnings of consolidated affiliates represent the share of net income or loss allocated to members or partners in our consolidated entities. As of June 30, 2006 and December 31, 2005, the number and average external ownership interest in these consolidated entities were as follows:

	As of June 30, 2006	**As of December 31, 2005**
Active consolidated affiliates	252	257
Average external ownership interest	33.7%	33.6%

Of our active consolidated affiliates at June 30, 2006 and December 31, 2005, approximately 79% of them are in our inpatient and surgery centers segments. Fluctuations in *Minority interests in earnings of consolidated affiliates* generally follow the same trends as our inpatient and surgery centers segments.

Loss from Continuing Operations Before Income Tax Expense

Our *Loss from continuing operations before income tax expense* (pre-tax loss from continuing operations) decreased for the three months ended June 30, 2006 compared to the same period of 2005 due primarily to the $18.6 million gain related to our interest rate swap and the management of operating expenses during this period of declining volumes.

Our pre-tax loss from continuing operations for the six months ended June 30, 2006 includes a $361.1 million *Loss on early extinguishment of debt* related to our recapitalization transactions in the first quarter of 2006. Our pre-tax loss from continuing operations for the six months ended June 30, 2005 includes a $215.0 million settlement associated with our securities litigation. If we exclude these items, our pre-tax loss from continuing operations for the six months ended June 30, 2006 is $71.5 million, and our pre-tax loss from continuing operations for the six months ended June 30, 2005 is $60.2 million, resulting in an increase of $11.3 million period over period. As discussed earlier in this Item, we recorded a $30.5 million net gain on lease termination during the six months ended June 30, 2005. Pre-tax loss from continuing operations for the six months ended June 30, 2006 includes a $14.8 million net gain on our interest rate swap and $12.9 million of gains related to Source Medical.

Provision for Income Tax Expense

We realized a $27.0 million income tax expense from continuing operations for the six months ended June 30, 2006 compared to a $20.4 million income tax expense for the same period of 2005. During the first quarter of 2006, we filed a request for a tax accounting method change which accelerated the amortization of certain indefinite-lived assets. This tax accounting method change gave rise to an additional difference between the book and tax bases of the assets effected and, accordingly, resulted in our recording an additional deferred tax liability and deferred tax expense of approximately $8.3 million related to these indefinite-lived assets during the six months ended June 30, 2006.

Adjusted Consolidated EBITDA

Management continues to believe that an understanding of Adjusted Consolidated EBITDA is an important measure of operating performance, leverage capacity, our ability to service our debt, and our ability to make capital expenditures.

We use Adjusted Consolidated EBITDA to assess our operating performance. We believe it is meaningful because it provides investors with a measure used by our internal decision makers for evaluating our business. Our internal decision makers believe Adjusted Consolidated EBITDA is a meaningful measure because it represents a transparent view of our recurring operating performance and allows management to readily view operating trends, perform analytical comparisons, and perform benchmarking between segments. Additionally, our management believes the inclusion of professional fees associated with litigation, financial restructuring, government investigations, forensic accounting, creditor advisors, accounting reconstruction, audit and tax work associated with the reconstruction process, and non-ordinary course charges incurred after March 19, 2003 and related to our overall corporate restructuring (including matters related to internal controls) distort within EBITDA their ability to efficiently assess and view the core operating trends on a consolidated basis and within segments. Additionally, we use Adjusted Consolidated EBITDA as a significant criterion in our determination of performance-based cash bonuses and stock awards. We reconcile Adjusted Consolidated EBITDA to *Net loss*.

We also use Adjusted Consolidated EBITDA on a consolidated basis as a liquidity measure. We believe this financial measure on a consolidated basis is important in analyzing our liquidity because it is also a component of certain material covenants contained within our new Credit Agreement, which is discussed in more detail in Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report. These covenants are material terms of the Credit Agreement, and the Credit Agreement represents a substantial portion of our capitalization. Non-compliance with these financial covenants under our Credit Agreement our interest coverage ratio and our leverage ratio could result in our lenders requiring us to immediately repay all amounts borrowed. In addition, if we cannot satisfy these financial covenants, we would be prohibited under our Credit Agreement from engaging in certain activities, such as incurring additional indebtedness, making certain payments, and acquiring and disposing of assets. Consequently, Adjusted Consolidated EBITDA is critical to our assessment of our liquidity.

In general terms, the definition of Adjusted Consolidated EBITDA, per our Credit Agreement, allows us to add back to Adjusted Consolidated EBITDA all unusual non-cash items or non-recurring items. These items include, but may not be limited to, (1) expenses associated with government, class action, and related settlements, (2) fees, costs, and expenses related to our recapitalization transactions, (3) any losses from discontinued operations and closed locations, (4) charges in respect of professional fees for reconstruction and restatement of financial statements, including fees paid to outside professional firms for matters related to internal controls, and (5) compensation expenses recorded in accordance with FASB Statement No. 123(R).

However, Adjusted Consolidated EBITDA is not a measure of financial performance under generally accepted accounting principles in the United States of America (GAAP), and the items excluded from Adjusted Consolidated EBITDA are significant components in understanding and assessing financial performance. Therefore, Adjusted Consolidated EBITDA should not be considered a substitute for net loss from continuing operations or cash flows from operating, investing, or financing activities. Because Adjusted Consolidated EBITDA is not a measurement determined in accordance with GAAP and is thus susceptible to varying calculations, Adjusted Consolidated EBITDA, as presented, may not be comparable to other similarly titled measures of other companies. Revenue and expenses are measured in accordance with the policies and procedures described in Note 1, *Summary of Significant Accounting Policies,* to our consolidated financial statements included in our 2005 Form 10-K.

Under our new Credit Agreement, our Adjusted Consolidated EBITDA for the three and six months ended June 30, 2006 and 2005 was as follows:

Reconciliation of Net Loss to Adjusted Consolidated EBITDA

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(In Thousands)			
Net loss	$ (42,436)	$ (62,413)	$ (477,574)	$ (320,617)
Loss from discontinued operations	4,409	6,949	17,994	25,015
Provision for income tax expense	9,086	9,540	27,019	20,418
Gain on interest rate swap	(18,604)		(14,789)	
(Gain) loss on sale of marketable securities	(55)	(21)	10	(21)
Interest income	(4,317)	(3,516)	(8,377)	(6,894)
Interest expense and amortization of debt discounts and fees	82,974	84,433	168,228	170,851
Loss on early extinguishment of debt	4,565	33	365,642	33
Professional fees accounting, tax, and legal	27,996	28,981	76,632	80,370
Government, class action, and related settlements expense	17,186		17,313	215,000
Impairment charges	3,860	12,978	3,860	24,915
Net non-cash loss on disposal of assets	6,159	3,503	5,814	13,601
Depreciation and amortization	38,917	40,199	75,851	89,038
Compensation expense under FASB Statement No. 123(R)	3,757		8,035	
Sarbanes-Oxley related costs	371	7,714	3,376	15,227
Restructuring activities under FASB Statement No. 146	2,077	5,584	3,245	7,238
Adjusted Consolidated EBITDA	$ 135,945	$ 133,964	$ 272,279	$ 334,174

Reconciliation of Adjusted Consolidated EBITDA to Net Cash Used In Operating Activities

	Six Months Ended June 30,	
	2006	2005
	(In Thousands)	
Adjusted Consolidated EBITDA	$ 272,279	$ 334,174
Professional fees accounting, tax, and legal	(76,632)	(80,370)
Sarbanes-Oxley related costs	(3,376)	(15,227)
Interest expense and amortization of debt discounts and fees	(168,228)	(170,851)
Interest income	8,377	6,894
Provision for doubtful accounts	52,585	46,321
Net gain on disposal of assets	(7,919)	(1,296)
Amortization of debt issue costs, debt discounts, and fees	14,345	22,067
Amortization of restricted stock	2,201	868
Accretion of debt securities	(53)	
(Gain) loss on sale of investments, excluding marketable securities	(1,953)	2,962
Equity in net income of nonconsolidated affiliates	(10,163)	(16,820)
Distributions from nonconsolidated affiliates	7,609	9,216
Minority interest in earnings of consolidated affiliates	57,217	57,057
Stock-based compensation	5,834	
Compensation expense under FASB Statement No. 123(R)	(8,035)	
Current portion of income tax provision	(10,865)	(12,464)
Restructuring charges under FASB Statement No. 146	(3,245)	(7,238)
Net cash settlement on interest rate swap	1,815	
Other operating cash used in discontinued operations	(4,098)	(33,544)
Change in government, class action, and related settlements liability	(56,213)	(114,337)
Change in assets and liabilities, net of acquisitions*	(122,046)	(47,773)
Net Cash Used In Operating Activities*	$ (50,564)	$ (20,361)

* See this Item, Liquidity and Capital Resources Sources and Uses of Cash, for a discussion of changes in operating cash and assets and liabilities. The change during the six months ended June 30, 2006 includes the payment of accrued interest on our prior indebtedness that was extinguished as part of our recapitalization transactions discussed below.

Adjusted Consolidated EBITDA increased for the three months ended June 30, 2006 compared to the same period of 2005 as we were able to offset our declining *Net operating revenues* through expense management during the quarter. For the six months ended June 30, 2006, Adjusted Consolidated EBITDA decreased compared to the same period of 2005 due primarily to the decrease in *Net operating revenues* as a result of declining volumes and the net gain on lease termination recorded for the Greenery facilities during the six months ended June 30, 2005.

Segment Results of Operations

Our internal financial reporting and management structure is focused on the major types of services provided by HealthSouth. We currently provide various patient care services through four operating divisions and certain other services through a fifth division, which correspond to our five reporting business segments: (1) inpatient, (2) surgery centers, (3) outpatient, (4) diagnostic, and (5) corporate and other. For additional information regarding our business segments, including a detailed description of the services we provide and financial data for each segment, please see Item 1, *Business*, and Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations*, to our 2005 Form 10-K and Note 12, *Segment Reporting,* to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

As part of the continued implementation of our strategic plan, management continues to evaluate the role of each segment and the services provided within each segment. Based on this evaluation, in the second quarter of 2006, our management realigned five electro-shock wave lithotripter units from our diagnostic segment to our corporate and other segment, as the services performed by these lithotripter units are not diagnostic services. We also realigned five occupational medicine centers from our corporate and other segment into our outpatient segment, as these centers provide therapy services that are consistent with other services provided by our outpatient segment. Prior periods have been reclassified to conform to this presentation.

Future changes to this organizational structure may result in changes to the reportable segments disclosed. For the three and six months ended June 30, 2006 and 2005, our results of operations by segment were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(In Thousands, Except Average Length of Stay)			
Net operating revenues				
Inpatient	$ 451,345	$ 459,098	$ 899,856	$ 934,996
Surgery Centers	191,261	197,985	384,213	403,581
Outpatient	85,682	98,479	175,217	201,170
Diagnostic	51,268	56,831	104,131	111,815
Corporate and Other	20,424	24,272	39,976	48,518
Operating earnings (loss)*				
Inpatient	$ 95,517	$ 109,603	$ 194,406	$ 206,862
Surgery Centers	20,113	21,920	46,557	52,203
Outpatient	7,535	5,687	16,835	15,165
Diagnostic	(12,059)	1,024	(15,081)	5,648
Corporate and Other	(76,478)	(98,616)	(166,517)	(388,131)
Volumes				
Inpatient				
Discharges	26	27	52	54
Outpatient visits	374	436	755	873
Average length of stay	15 days	16 days	15 days	16 days
Surgery Centers				
Cases	151	160	300	317
Outpatient				
Visits	844	1,016	1,706	2,043
Diagnostic				
Scans	170	184	346	366

* Results of operations for each operating segment include divisional overhead, but exclude corporate overhead. All corporate overhead is included in our corporate and other segment. See Note 25, *Segment Reporting*, to the financial statements included in our 2005 Form 10-K for additional information. Operating earnings (loss) includes the effect of minority interests in earnings of consolidated affiliates and equity in the net income of nonconsolidated affiliates.

Inpatient

For the three months ended June 30, 2006 and 2005, our inpatient segment comprised approximately 57.3% and 56.1%, respectively, of consolidated *Net operating revenues*. For the six months ended June 30, 2006 and 2005, our inpatient segment comprised approximately 57.0% and 56.2%, respectively, of consolidated *Net operating revenues*.

During the second quarter of 2006 and in the weeks prior to the filing of this report, the following notable events occurred within our inpatient segment:

In April 2006, HealthSouth Ridge Lake Hospital, our 40-bed long term acute care hospital in Sarasota, Florida, received its license approval.

In June 2006, we opened HealthSouth Rehabilitation Hospital of Petersburg, a 40-bed rehabilitation facility in Petersburg, Virginia.

In August 2006, we signed a definitive agreement to sell Cedar Court Rehabilitation Hospital in Melbourne, Australia, and related assets (Cedar Court), to Epworth Foundation and ING Management Limited. The Cedar Court assets include a 74-bed rehabilitation hospital and outpatient center, a stand alone rehabilitation facility at the Oasis Leisure Center, and an occupational medicine rehabilitation therapy business. The transaction is still subject to customary closing conditions, including clearance under the Australian Competition and Consumer Commission, the Victorian Department of Human Services, and other regulatory approvals.

In August 2006, we also announced the signing of a letter of intent to partner with TMC HealthCare in Tucson, Arizona to provide rehabilitation services. Under the proposed agreement, HealthSouth Rehabilitation Institute of Tucson would provide rehabilitation and therapy services currently provided at El Dorado Hospital in Tucson and select TMC outpatient therapies.

The lease associated with Central Georgia Rehabilitation Hospital in Macon, Georgia will not be extended. This lease expires on September 30, 2006. This facility includes 58 rehabilitation beds and an outpatient rehabilitation satellite facility.

None of the above events or transactions, individually or in the aggregate, is expected to have a material impact on the results of operations, financial position, or cash flows of our inpatient segment or to HealthSouth on a consolidated basis.

In addition, on August 1, 2006, CMS released a final rule that updates the IRF-PPS for the federal fiscal year 2007 (which covers discharges occurring on or after October 1, 2006 and on or before September 30, 2007). Although the final rule includes an overall market basket update of 3.3%, this market basket update will be offset by a 2.6% reduction in standard payment rates. This coding reduction is in addition to the 1.9% reduction implemented in federal fiscal year 2006. We estimate that the final rule will increase our inpatient segment s net Medicare revenues by approximately $5 million per quarter for federal fiscal year 2007 as compared to federal fiscal year 2006.

Net Operating Revenues

Our inpatient segment s *Net operating revenues* for the three months ended June 30, 2006 were 1.7% lower than the comparable period of 2005. The decrease was primarily due to a reduction of non-compliant case volumes. Discharges were approximately 3.7% lower than the same period of 2005 due to the continued phase-in of the 75% Rule. Our inpatient segment also experienced a 14.2% decrease in outpatient volumes due to the decrease in our inpatient volumes, changes in patient-program mix, shortages in therapy staffing, and continued competition from physicians offering physical therapy services within their own offices. Certain regulatory pricing changes implemented as of October 1, 2005 also negatively impacted *Net operating revenues* for the

quarter. These changes are discussed in more detail in Item 7, *Management s Discussion and Analysis of Financial Condition*, Segment Results of Operations Inpatient, to our 2005 Form 10-K. However, we were able to mitigate a portion of these unit price reductions by achieving an approximate 4.8% compliant case growth during the three months ended June 30, 2006 compared to the same period of 2005. This compliant case growth also increased the acuity of our patients quarter over quarter.

Our inpatient segment s *Net operating revenues* for the six months ended June 30, 2006 were 3.8% lower than the comparable period of 2005. The decrease was primarily due to a reduction of non-compliant case volumes. Discharges were approximately 3.7% lower than the same period of 2005 due to the continued phase-in of the 75% Rule. Our inpatient segment also experienced a 13.5% decrease in outpatient volumes due to the reasons described above for the three months ended June 30, 2006. The regulatory pricing changes mentioned above also negatively impacted the results for the six months ended June 30, 2006 compared to the same period of 2005. During the six months ended June 30, 2006, we achieved compliant case growth of approximately 5.8% to mitigate a portion of these unit price reductions.

Operating Earnings

Operating earnings of our inpatient segment decreased quarter over quarter due to continued volume decline as well as increased labor and supply costs without a proportionate increase in pricing. As discussed earlier in this Item, the increased acuity of our patients results in increased labor and supply costs during this period of declining unit pricing within our inpatient segment. Operating earnings for the three months ended June 30, 2006 also include a $4.1 million net loss on asset disposals compared to a $3.7 million net gain on asset disposals during the same period of 2005.

Operating earnings of our inpatient segment also decreased for the six months ended June 30, 2006 when compared to the comparable period of 2005 due primarily to the declining volumes and lack of proportionate increase in pricing compared to expenses being incurred, as discussed above.

Our inpatient facilities are currently operating at the applicable minimum qualifying patient mix threshold under the 75% Rule. During the second half of 2006, due in large part to our continued compliance with the 75% Rule, our inpatient segment s results of operations will continue to be negatively impacted as compared to the same periods of 2005. During the third quarter of 2006, the segment will also continue to be negatively impacted by the unit price reductions resulting from IRF-PPS changes that became effective October 1, 2005. To combat these issues, we will continue to aggressively attempt to mitigate the impact of the 75% Rule by focusing our marketing efforts on compliant cases, managing our expenses by standardizing our labor and supply practices, and developing new post-acute services that are complementary to our IRFs.

Surgery Centers

Net Operating Revenues

Net operating revenues for the three months ended June 30, 2006 were $6.7 million, or 3.4%, lower than the comparable period of 2005. Approximately $4.0 million of the decrease was due to three surgery centers that became equity method investments rather than consolidated entities after the second quarter of 2005. The remainder of the decrease was primarily due to seven facility closures, quarter over quarter, which did not qualify as discontinued operations, as well as market competition and physician turnover.

Net operating revenues for the six months ended June 30, 2006 were $19.4 million, or 4.8%, lower than the comparable period of 2005. Approximately $9.5 million of the decrease is due to four surgery centers that became equity method investments rather than consolidated entities during the applicable period. An additional $4.2 million of the decrease is due to seven facility closures that occurred after July 1, 2005 that did not qualify as discontinued operations. The remaining decrease resulted from market competition and physician turnover.

Operating Earnings

Operating earnings for the three and six months ended June 30, 2006 include approximately $1.6 million of long-lived asset impairment charges. Facility closings and facilities experiencing negative cash flows from operations resulted in the segment recognizing an impairment charge. We determined the fair value of the impaired long-lived assets based on the assets estimated fair value using valuation techniques that included discounted cash flows and third-party appraisals. A similar charge of approximately $0.2 million is included in the segment s operating earnings for the six months ended June 30, 2005.

Operating earnings for the three and six months ended June 30, 2006 decreased due to the declining volumes discussed above. However, excluding the impairment charges discussed above, operating earnings as a percent of *Net operating revenues* increased slightly from 11.1% to 11.3% during the three months ended June 30, 2006 and 2005, respectively. For the six months ended June 30, 2006 and 2005, operating earnings as a percent of *Net operating revenues*, excluding impairment charges, were 12.5% and 13.0%, respectively. Operating earnings for the six months ended June 30, 2005 include the recovery of equity losses from nonconsolidated affiliates.

Our focus within our surgery centers segment continues to be on increasing volumes and continuing our resyndication activities. Consistent with the results of operations for the second quarter of 2006, we expect to continue to see margin expansion through labor and supply cost management initiatives, including the standardization of non-physician preference items. However, this margin expansion could be impacted by an increase in minority interests as we continue our resyndication efforts.

On August 8, 2006, CMS issued a proposed rule that would substantially change Medicare reimbursement for ASC procedures. The proposed rule would revise ASC payment rates to be based on 221 Ambulatory Payment Classifications currently used to categorize procedures under the hospital outpatient prospective payment system (OPPS) and would tentatively set calendar year 2008 ASC payment rates at 62% of applicable OPPS payment rates. Beginning in 2010, the ASC conversion factor would be updated by the consumer price index for urban consumers. The proposed rule would also expand the list of ASC approved procedures by 14 effective January 1, 2007 and, beginning in 2008 with the implementation of the revised ASC payment system, would expand the approved list of ASC procedures to include all surgical procedures other than those that pose a significant safety risk or generally require an overnight stay. For procedures commonly performed in physicians offices, the proposed rule would limit ASC payments to the lesser of the non-facility practice expense payment under the Medicare Physician Fee Schedule or the new ASC payment rates for those procedures.

The proposed rule would also implement a provision of the Deficit Reduction Act of 2005 that caps payment for ASC procedures in 2007 to the lesser of the ASC or OPPS payment rate.

CMS proposes to phase in the new payment system over two years. While difficult to predict, we believe these proposed changes could have a neutral to positive impact on our surgery centers segment s *Net operating revenues* once the new system is in place, depending upon the rule s overall effect on unit pricing and our ability to realize increased case volume as the list of approved ASC procedures is expanded. However, the proposed rule has not been finalized and we cannot provide any assurance that the rule will be finalized in its current form or that the rule, if finalized in its current form, will have the impact we predict. If the final rule results in a downward adjustment to ASC reimbursement rates or limits the expansion of covered surgical procedures, it could have a material adverse effect on our business, financial position, results of operations, and cash flows. We are working with a coalition of ASC companies and associations to provide data to CMS supporting a number of modifications to the proposed rule. We believe that the current proposal misses an opportunity to achieve additional long-term savings in Medicare outpatient surgery costs by establishing a more appropriate payment balance among hospital outpatient departments, ASCs, and physician offices.

Outpatient

Net Operating Revenues

Patient visits to our outpatient facilities for the three and six months ended June 30, 2006 were 16.9% and 16.5%, respectively, lower than the comparable periods of 2005. This decreased volume negatively impacted *Net operating revenues* by approximately $15.9 million during the three months ended June 30, 2006 and approximately $31.6 million during the six months ended June 30, 2006. Management attributes the volume decline in each period to continued competition from physician-owned physical therapy sites, the nationwide physical therapist shortage, closures of underperforming facilities in 2005, and the annual per-beneficiary limitations on Medicare outpatient therapy services that became effective on January 1, 2006.

In both the three and six months ended June 30, 2006, our outpatient segment was able to offset the negative revenue impact of declining volumes by achieving higher net patient revenue per visit due to its examination and elimination of managed care contracts with low reimbursement rates and an increase in manual therapy services.

Operating Earnings

Operating earnings for the three and six months ended June 30, 2006 showed improvement in terms of dollars and as a percent of *Net operating revenues*. These increases reflect our outpatient segment s efforts to control expenses while implementing marketing objectives that should increase visits and market share during 2006.

In July 2006, we closed a transaction to acquire the assets of Hurrle Orthopaedic Physical Therapy, P.C. (Hurrle). This transaction gave HealthSouth ownership of Hurrle s seven outpatient physical therapy facilities in the Indianapolis, Indiana area. The centers provide a number of outpatient rehabilitation services including physical therapy, sports medicine, and occupational therapy. In connection with this acquisition, we entered into noncompete agreements with the former owners and key employees of Hurrle. We also assumed certain facility operating leases as part of the acquisition. We will account for this acquisition under the purchase method of accounting and will report the results of operations for each of these acquired centers from the date of acquisition as part of our outpatient segment. The results of operations of these acquired centers and assets are not material to our outpatient segment or to HealthSouth on a consolidated basis.

Our facility rationalization and marketing initiatives within our outpatient segment are beginning to improve the segment s operating results. However, we expect to continue to be negatively impacted by continued competition from physician-owned physical therapy sites and the annual per-beneficiary limitations on Medicare outpatient therapy services. The extent of the impact of these limitations will depend on both the administration of the medical necessity exception process by the Centers for Medicare & Medicaid Services and the response of possible deferral of therapy treatment by patients subject to the therapy caps. For additional information regarding these limits, see Item 1, *Business*, Sources of Revenues, to our 2005 Form 10-K.

Diagnostic

Net Operating Revenues

Net operating revenues for the three and six months ended June 30, 2006 decreased by 9.8% and 6.9%, respectively, over the comparable periods in 2005. These declines are attributable to lower scan volumes and, to a lesser extent, a shift in case mix to lower paying modalities relative to comparable periods in 2005. The segment s volume declines are primarily attributable to competition from physician-owned diagnostic centers and the closure of underperforming facilities during the latter part of 2005 and the first half of 2006 that did not qualify as discontinued operations.

Operating (Loss) Earnings

Operating earnings of our diagnostic segment decreased for the three and six months ended June 30, 2006 due to declining volumes and an increase in operating expenses caused by non-capitalizable implementation charges related to a new enterprise information technology system, increased professional fees associated with the outsourcing of collection activities, and the repairs and maintenance of equipment. In addition, approximately $5.2 million of the decrease in the six months ended June 30, 2006 is due to a reassessment of our *Refunds due patients and other third-party payors* liability in 2005 to update for allocations to various state jurisdictions and other payors. This change in estimate reduced our *Refunds due patients and other third-party payors* liability for our diagnostic segment by approximately $5.2 million in the first quarter of 2005, thereby reducing our expenses. Operating loss for the three and six months ended June 30, 2006 also includes a $2.0 million loss on disposal of assets. In addition, facility closings and facilities experiencing negative cash flow from operations resulted in the segment recognizing a $2.0 million impairment charge related to long-lived assets during the second quarter of 2006. We determined the fair value of the impaired long-lived assets at a facility primarily based on the assets estimated fair value using valuation techniques that included discounted future cash flows and third-party appraisals.

This segment s new management team is focusing its efforts to increase scan volumes by expanding our relationships with new referral sources and installing new equipment at select facilities. We are also evaluating our portfolio of facilities, particularly those that are underperforming. We will continue the implementation of a new enterprise information technology system that will provide a fully-integrated information technology solution for the division, including remote picture archiving communication systems that allow for the remote reading of scans performed by our centers and enhanced management information reporting. We believe the implementation of this system will also improve our collection activities. While these actions should result in improvement in the segment s operating results, we anticipate that our operating performance over the next two quarters will be impacted by the non-recurring costs associated with these changes.

Corporate and Other

Net Operating Revenues

Changes in *Net operating revenues* from period to period primarily relate to changes in earned premiums of HCS, Ltd., a wholly owned subsidiary that handles medical malpractice, workers compensation, and other claims for HealthSouth. These revenues eliminate in consolidation.

Operating Loss

For the three months ended June 30, 2006, the decrease in the operating loss for our corporate and other segment when compared to the same period of 2005 was due primarily to a decrease in consulting fees for strategic planning and other projects, a decrease in impairment charges, a decrease in insurance costs, and receipt of fully reserved notes receivable from Source Medical offset by an increase in *Government, class action, and related settlements expense*. In the second quarter of 2005, we incurred an impairment charge of approximately $13.0 million, primarily related to our Digital Hospital. The impairment of the Digital Hospital was determined using a weighted average fair value approach that considered a 2003 appraisal of the property and other potential scenarios. This segment s operating loss for the second quarter of 2006 includes a $6.9 million gain related to payment of a fully reserved note receivable from Source Medical, as discussed in Note 3, *Investment in and Advances to Nonconsolidated Affiliates*, to our accompanying condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*. The corporate and other segment s operating loss for the second quarter of 2006 also includes approximately $16.7 million under the caption *Government, class action, and related settlements expense*. This amount includes $3.0 million related to the non-prosecution agreement reached with the DOJ, $10.7 million related to ongoing settlement discussions with our subsidiary

partnerships, and $3.0 million related to ongoing settlement discussions relating to *qui tam* claims, as discussed earlier in this Item, Consolidated Results of Operations.

Our operating loss for the corporate and other segment decreased for the six months ended June 30, 2006 when compared to the same period of 2005 due primarily to the securities litigation settlement discussed in Note 10, *Settlements*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report. The results for the six months ended June 30, 2005 also include $23.5 million of long-lived asset impairment charges, including the Digital Hospital discussed above. We determined the fair value of the impaired long-lived assets based on the assets estimated fair value using valuation techniques that included discounted future cash flows and third-party appraisals. As discussed above in this Item, Consolidated Results of Operations, this segment s results of operations for the six months ended June 30, 2005 also include a $30.5 million net gain resulting from the lease termination of the Greenery facilities. This segment s operating loss for the six months ended June 30, 2006 includes the removal of the $6.0 million liability related to Source Medical and the repayment of the $6.9 million note receivable from Source Medical, as discussed above and in Note 3, *Investment in and Advances to Nonconsolidated Affiliates*, to our accompanying condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*.

We continue to strive to control costs associated with our corporate and other segment, but this is difficult due to our continued investment in our infrastructure (both people and technology). We continue to focus on the remediation of internal controls, including the implementation of our information technology strategic plan. We continue to replace the work performed by external consultants during the reconstruction period with HealthSouth employees, and we continue to add resources to provide the necessary level of support to our facilities and meet our operational needs.

Results of Discontinued Operations

During the three months ended June 30, 2006, we identified one entity within our inpatient segment, four surgery centers, thirteen outpatient rehabilitation facilities, and three diagnostic centers that met the requirements of FASB Statement No. 144 to report as discontinued operations. During the six months ended June 30, 2006, we identified one entity within our inpatient segment, four surgery centers, twenty outpatient rehabilitation facilities, three diagnostic centers, and one other facility that met the requirements of FASB Statement No. 144 to report as discontinued operations. For the facilities identified during these periods that met the requirements of FASB Statement No. 144 to report as discontinued operations, we reclassified our condensed consolidated balance sheet as of December 31, 2005, presented our condensed consolidated statements of operations and comprehensive loss for the three and six months ended June 30, 2005, and presented our statement of cash flows for the six months ended June 30, 2005 to show the results of those facilities as discontinued operations.

The operating results of discontinued operations, by operating segment and in total, are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(In Thousands)			
Inpatient:				
Net operating revenues	$ 194	$ 225	$ 338	$ 491
Costs and expenses	546	611	1,074	1,396
Impairments	1,836		1,836	
Loss from discontinued operations	(2,188)	(386)	(2,572)	(905)
Gain on disposal of assets of discontinued operations			69	362
Income tax expense				
Loss from discontinued operations	$ (2,188)	$ (386)	$ (2,503)	$ (543)
Surgery Centers:				
Net operating revenues	$ 496	$ 8,344	$ 2,136	$ 18,107
Costs and expenses	1,982	10,481	4,156	23,393
Impairments				
Loss from discontinued operations	(1,486)	(2,137)	(2,020)	(5,286)
Gain on disposal of assets of discontinued operations	960	3,125	6,389	2,860
Income tax expense				
(Loss) income from discontinued operations	$ (526)	$ 988	$ 4,369	$ (2,426)
Outpatient:				
Net operating revenues	$ 537	$ 5,041	$ 965	$ 11,157
Costs and expenses	693	6,246	1,758	13,205
Impairments				
Loss from discontinued operations	(156)	(1,205)	(793)	(2,048)
Gain (loss) on disposal of assets of discontinued operations	8	(13)	(266)	455
Income tax expense				
Loss from discontinued operations	$ (148)	$ (1,218)	$ (1,059)	$ (1,593)
Diagnostic:				
Net operating revenues	$ 311	$ 1,212	$ 828	$ 3,182
Costs and expenses	944	2,094	2,142	4,951
Impairments	434		958	
Loss from discontinued operations	(1,067)	(882)	(2,272)	(1,769)
(Loss) gain on disposal of assets of discontinued operations	(55)	(162)	(431)	587
Income tax expense				
Loss from discontinued operations	$ (1,122)	$ (1,044)	$ (2,703)	$ (1,182)
Corporate and Other:				
Net operating revenues	$ 3,572	$ 22,192	$ 14,216	$ 56,070
Costs and expenses	3,996	27,567	23,008	69,009
Impairments				6,589
Loss from discontinued operations	(424)	(5,375)	(8,792)	(19,528)
(Loss) gain on disposal of assets of discontinued operations	(1)	86	(7,306)	257
Income tax expense				

Loss from discontinued operations	$ (425)	$ (5,289)	$ (16,098)	$ (19,271)
Total:				
Net operating revenues	$ 5,110	$ 37,014	$ 18,483	$ 89,007
Costs and expenses	8,161	46,999	32,138	111,954
Impairments	2,270		2,794	6,589
Loss from discontinued operations	(5,321)	(9,985)	(16,449)	(29,536)
Gain (loss) on disposal of assets of discontinued operations	912	3,036	(1,545)	4,521
Income tax expense				
Loss from discontinued operations	$ (4,409)	$ (6,949)	$ (17,994)	$ (25,015)

Inpatient. During the second quarter of 2006, our inpatient segment identified one entity as a discontinued operation. We recorded an impairment charge of $1.8 million during the three months ended June 30, 2006 based on the difference between the expected sales price and the net book value of this entity.

Our inpatient segment did not identify any other facilities as discontinued operations in 2005 or 2006. Costs and expenses during these periods primarily reflect run-off costs associated with facilities identified in prior periods. Net operating revenues reflect rental income related to the entity discussed above.

Surgery Centers. During the three and six months ended June 30, 2006, four surgery centers were identified as discontinued operations. Fourteen surgery centers were identified as discontinued operations throughout 2005. Both the decline in net operating revenues and the decline in costs and expenses in each period were due to the timing of the sale or closure of these facilities.

The net gain on asset disposals for the three months ended June 30, 2006 primarily relates to a net gain of $1.5 million related to the sale of one of our Florida surgery centers offset by a $0.5 million net loss on the sale of one of our surgery centers in Pennsylvania. For the six months ended June 30, 2006, the net gain on asset disposals also includes an approximate $5.4 million gain recorded on the sale of three facilities located in Tennessee and Florida during the first quarter of 2006. The net gain on asset disposals for the three and six months ended June 30, 2005 primarily relate to gains recorded on the sale of two surgery centers in Arizona and one in Florida.

Outpatient. Our outpatient segment identified thirteen facilities as discontinued operations during the three months ended June 30, 2006 and identified a total of twenty facilities as discontinued operations during the six months ended June 30, 2006. During 2005, our outpatient segment identified 185 facilities as discontinued operations. The timing of the closure of these facilities drove the change in net operating revenues and costs and expenses in each period.

Diagnostic. Our diagnostic segment identified three facilities as discontinued operations during the three and six months ended June 30, 2006. During 2005, our diagnostic segment identified seven facilities as discontinued operations. The timing of the closure of these facilities drove the change in net operating revenues and costs and expenses in each period.

Corporate and Other. During the six months ended June 30, 2006, our corporate and other segment identified one facility as discontinued operations. During 2005, our corporate and other segment identified eleven facilities as discontinued operations.

On July 20, 2005, we executed an asset purchase agreement with The Board of Trustees of the University of Alabama (the University of Alabama) for the sale of the real property, furniture, fixtures, equipment and certain related assets associated with our only remaining operating acute care hospital, which had 219 licensed beds located in Birmingham, Alabama (the Birmingham Medical Center). Simultaneously with the execution of this purchase agreement with the University of Alabama, we executed an agreement with an affiliate of the University of Alabama whereby this entity provided certain management services to the Birmingham Medical Center. On December 31, 2005, we executed an amended and restated asset purchase agreement with the University of Alabama. This amended and restated agreement provided that the University of Alabama purchase the Birmingham Medical Center and associated real and personal property as well as our interest in the gamma knife partnership associated with this hospital. This transaction closed on March 31, 2006. We transferred the hospital and associated real and personal property at that time, but will transfer our interest in the gamma knife partnership at a later date. The transaction also required that we acquire and convey title to the University of Alabama or its affiliate for certain professional office buildings that we leased. Both the certificate of need under which the hospital operated and the licensed beds operated by us at the hospital were transferred as part of the sale of the hospital under the amended and restated agreement.

The change in net operating revenues and costs and expenses between the two comparable periods in 2006 and 2005 relates primarily to the performance and eventual sale of the Birmingham Medical Center. The $6.6 million impairment charge in the six months ended June 30, 2005 primarily relates to an impairment charge for a closed medical center. The $7.3 million net loss on asset disposals in the six months ended June 30, 2006 was the result of our sale of the Birmingham Medical Center and lease termination fees associated with certain properties adjacent to the Birmingham Medical Center. See Note 7, *Discontinued Operations*, to our accompanying condensed consolidated financial statements included in Part I, Item 1, *Financial Statements (Unaudited)*, for additional information.

Liquidity and Capital Resources

Our principal sources of liquidity are cash on hand, cash from operations, and our revolving credit agreement.

Sources and Uses of Cash

Our primary sources of funding are cash flows from operations, borrowings under long-term debt agreements, and sales of limited partnership interests. The following chart shows the cash flows provided by or used in operating, investing, and financing activities for the six months ended June 30, 2006 and 2005, as well as the effect of exchange rates for those same periods:

	Six Months Ended June 30,	
	2006	2005
	(In Thousands)	
Net cash used in operating activities	$ (50,564)	$ (20,361)
Net cash provided by (used in) investing activities	33,587	(24,725)
Net cash used in financing activities	(105,575)	(131,973)
Effect of exchange rate changes on cash and cash equivalents	(123)	(314)
Decrease in cash and cash equivalents	$ (122,675)	$ (177,373)

Operating activities. Net cash used in operating activities increased for the six months ended June 30, 2006 compared to the same period of 2005 primarily because of volume declines, as discussed above. As shown by the following chart, additional changes in net cash used in operating activities resulted from the timing of certain disbursements, including government settlements, interest, payroll, and other accruals, including professional fees:

	Six Months Ended June 30,	
	2006	2005
	(In Thousands)	
Net cash used in operating activities	$ (50,564)	$ (20,361)
Change in government, class action, and related settlements	56,213	114,337
Net cash provided by operating activities, excluding government, class action and related settlements	5,649	93,976
Period over period increase in:		
Interest	25,760	N/A
Payroll	18,422	N/A
Other accrued expenses, including professional fees	41,331	N/A
	$ 91,162	$ 93,976

Investing activities. Net cash provided by investing activities increased for the six months ended June 30, 2006 when compared to the same period of 2005 due primarily to proceeds from asset disposals, including the disposal of assets for facilities that qualify as discontinued operations, and proceeds from the sale or maturity of marketable securities. These marketable securities were sold to pay financing fees associated with our recapitalization transactions discussed below. Capital expenditures were also $9.2 million less during the six months ended June 30, 2006 compared to the same period of 2005.

Financing activities. The decrease in net cash used in financing activities for the six months ended June 30, 2006 compared to the same period of 2005 is due to the recapitalization transactions and private offering of senior notes discussed below. As a result of these transactions, net payments on debt, including capital lease

obligations, increased by approximately $271.6 million for the six months ended June 30, 2006. We also paid approximately $59.8 million more in debt issuance costs during the six months ended June 30, 2006 over the same period of 2005 due to these transactions. These increased payments were offset by approximately $387.4 million in net proceeds from the issuance of convertible perpetual preferred stock, as discussed below.

Current Liquidity and Capital Resources

As of June 30, 2006, we had approximately $53.9 million in cash and cash equivalents. This amount excludes approximately $176.2 million in restricted cash and $51.5 million of restricted marketable securities, which are assets we cannot use because of various obligations we have under lending agreements, partnership agreements, and other arrangements, primarily related to our captive insurance company. As of December 31, 2005, we had approximately $175.6 million in cash and cash equivalents, $242.5 million in restricted cash, and $23.8 million of non-restricted marketable securities.

On March 10, 2006, we completed the last of a series of recapitalization transactions (the Recapitalization Transactions) enabling us to prepay substantially all of our prior indebtedness and replace it with approximately $3 billion of new long-term debt. Although we remain highly leveraged, we believe these Recapitalization Transactions have eliminated significant uncertainty regarding our capital structure and have improved our financial condition in several important ways:

Reduced refinancing risk The terms governing our prior indebtedness would have required us to refinance approximately $2.7 billion between 2006 and 2009, assuming all noteholders holding options to require us to repurchase their notes in 2007 and 2009 were to exercise those options. Under the terms governing our new indebtedness, we have minimal maturities until 2013 when our new term loans come due. The extension of our debt maturities has substantially reduced the risk and uncertainty associated with our near-term refinancing obligations under our prior debt.

Improved operational flexibility We have negotiated new loan covenants with higher leverage ratios and lower interest coverage ratios. In addition, our new loan agreements increase our ability to enter into certain transactions (e.g. acquisitions and sale-leaseback transactions).

Increased liquidity As a result of the Recapitalization Transactions, our revolving line of credit has increased by approximately $150 million. In addition, the increased flexibility provided by the covenants governing our new indebtedness will allow us greater access to our revolving credit facility than we had under our prior indebtedness.

Improved credit profile By issuing $400 million in convertible perpetual preferred stock and using the net proceeds from that offering to repay a portion of our outstanding indebtedness and to pay fees and expenses related to such prepayment, we were able to reduce the amount we ultimately borrowed under the interim loan agreement. Accordingly, we have improved our capital structure. In addition, by increasing the ratio of our secured debt to unsecured debt, our capital structure is now closer to industry norms. Further, a substantial amount of our new indebtedness is prepayable without penalty, which will enable us to reduce debt and interest expense as operating and non-operating cash flows allow without the substantial cost associated with the prepayment of our prior public indebtedness.

The Recapitalization Transactions included (1) entering into credit facilities that provide for extensions of credit of up to $2.55 billion of senior secured financing, (2) entering into an interim loan agreement that provided us with $1.0 billion of senior unsecured financing, (3) completing a $400 million offering of convertible perpetual preferred stock, (4) completing cash tender offers to purchase $2.03 billion of our previously outstanding senior notes and $319 million of our previously outstanding senior subordinated notes and consent solicitations with respect to proposed amendments to the indentures governing each outstanding series of notes, and (5) prepaying and terminating our Senior Subordinated Credit Agreement, our Amended and Restated Credit Agreement, and our Term Loan Agreement. In order to complete the Recapitalization Transactions, we also entered into amendments, waivers, and consents to our prior senior secured credit facility, $200 million senior

unsecured term loan agreement, and $355 million senior subordinated credit agreement. Detailed descriptions of each of the above transactions are contained in Item 1, *Business*, Recapitalization Transactions, of our 2005 Form 10-K and Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

We used a portion of the proceeds of the loans under the new senior secured credit facilities, the proceeds of the interim loans, and the proceeds of the $400 million offering of convertible perpetual preferred stock, along with cash on hand, to prepay substantially all of our prior indebtedness and to pay fees and expenses related to such prepayment and the Recapitalization Transactions. The remainder of the proceeds and availability under the senior secured credit facilities are expected to be used for general corporate purposes. In addition, the letters of credit issued under the revolving letter of credit subfacility and the synthetic letter of credit facility will be used in the ordinary course of business to secure workers compensation and other insurance coverages and for general corporate purposes.

In June 2006, we repaid our Interim Loan Agreement using cash on hand and the proceeds from a private offering of $1.0 billion aggregate principal amount of senior notes, which included $375 million in aggregate principal amount of floating rate senior notes due 2014 (the Floating Rate Notes) at par and $625 million aggregate principal amount of 10.750% senior notes due 2016 at 98.505% of par. The Floating Rate Notes will bear interest at a per annum rate equal to LIBOR plus 6.0%. For additional information regarding this transaction, see Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

The face value of our long-term debt (excluding notes payable to banks and others, noncompete agreements, and capital lease obligations) before and after the transactions described above is summarized in the following table:

	As of June 30, 2006	As of December 31, 2005
	(In Thousands)	
Revolving credit facility	$ 50,000	$
Term loans	2,050,000	513,425
Bonds payable	1,063,153	2,720,907
	$ 3,163,153	$ 3,234,332

The following charts show our scheduled payments on long-term debt (excluding notes payable to banks and others, noncompete agreements, and capital lease obligations) as of December 31, 2005 (before the Recapitalization Transactions and private offering of senior notes) and as of June 30, 2006 (after the Recapitalization Transactions and private offering of senior notes) for the next five years (including 2006) and thereafter. The charts also exclude the convertible perpetual preferred stock.

As noted above, we have negotiated new debt covenants as part of the Recapitalization Transactions. These covenants include higher leverage ratios and lower interest coverage ratios. The following chart shows a comparison of these two restrictive covenants as of June 30, 2006 under our former Amended and Restated Credit Agreement and our new Credit Agreement:

	Required Ratios at June 30, 2006	
	New Senior Credit Facility	**Former Amended and Restated Credit Agreement**
Minimum interest coverage ratio	1.65 to 1.00	2.00 to 1.00
Maximum leverage ratio	7.25 to 1.00	5.50 to 1.00

Funding Commitments

After the above Recapitalization Transactions and private offering of senior notes, we have scheduled payments of $36.2 million and $44.5 million in the remainder of 2006 and 2007, respectively, related to long-term debt obligations (including notes payable to banks and others, noncompete agreements, and capital lease obligations). For additional information about our long-term debt obligations, see Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

We also have funding commitments related to legal settlements. As a result of the Medicare Program Settlement discussed in Item 1, *Business*, to our 2005 Form 10-K, we made principal payments of approximately $196.3 million to the United States during 2005 and the six months ended June 30, 2006. The remaining principal balance of $128.7 million will be paid in quarterly installments throughout the remainder of 2006 and 2007. These amounts are exclusive of interest from November 4, 2004 at an annual rate of 4.125%. In addition to the Medicare Program Settlement, we reached an agreement with the SEC to resolve claims brought by the SEC against us in March 2003. As a result of the SEC Settlement, we made a $12.5 million payment to the SEC in October 2005 and a $12.5 million payment in April 2006. We will make payments of $25 million and $50 million in the remainder of 2006 and 2007, respectively.

During the six months ended June 30, 2006, we made capital expenditures of approximately $43.2 million. Total amounts budgeted for capital expenditures for 2006 approximate $147 million. These expenditures include IT initiatives, new business opportunities, and equipment upgrades and purchases. Approximately 50% of this budgeted amount is discretionary and could be revised, if necessary.

Off-Balance Sheet Arrangements

In accordance with the definition under SEC rules, the following qualify as off-balance sheet arrangements:

- any obligation under certain guarantees or contracts;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
- any obligation under certain derivative instruments; and
- any obligation under a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant.

The following discussion addresses each of the above items for our company.

On June 30, 2006, we were liable for guarantees of indebtedness owed by third parties in the amount of $25.9 million. We have recognized that amount as a liability as of June 30, 2006 because of existing defaults by the third parties under those guarantees.

We are also secondarily liable for certain lease obligations associated with sold facilities. As of June 30, 2006, we had entered into five such sublease guarantee arrangements. The remaining terms of these subleases range from six months to eight years. If we were required to perform under all such guarantees, the maximum amount we would be required to pay approximates $12.6 million. We have not recorded a liability for these guarantees, as we do not believe it is probable that we will be required to perform under these agreements. In the event we are required to perform under these guarantees, we could potentially have recourse against the sublessee for recovery of any amounts paid. For additional information regarding these guarantees, see Note 2, *Guarantees*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

As of June 30, 2006, we were not directly liable for the debt of any unconsolidated entity, and we do not have any retained or contingent interest in assets as defined above.

As of June 30, 2006, we hold one derivative financial instrument, as defined by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended. In March 2006, we entered into an interest rate swap related to our new Credit Agreement, as discussed in Note 4, *Long-term Debt*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities (SPEs), which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of June 30, 2006, we are not involved in any unconsolidated SPE transactions.

Contractual Obligations

Our consolidated contractual obligations as of June 30, 2006 are as follows:

	Total	July 1, 2006 through December 31, 2006	2007 - 2008	2009 - 2010	2011 and Thereafter
			(In Thousands)		
Long-term debt obligations:					
Long-term debt, excluding revolving credit facility and capital lease obligations[a]	$ 3,109,397	$ 27,041	$ 86,192	$ 44,769	$ 2,951,395
Revolving credit facility	50,000				50,000
Interest on long-term debt[b]	2,183,369	147,042	580,012	565,745	890,570
Capital lease obligations[c]	245,358	15,174	59,224	53,215	117,745
Operating lease obligations[d][e][f]	461,931	53,147	163,304	93,240	152,240
Purchase obligations[f][g]	132,308	48,287	54,344	6,184	23,493
Other long-term liabilities:					
Government settlements, including interest when applicable	208,536	69,512	139,024		
Other liabilities[h]	4,419	777	467	444	2,731

(a) Included in long-term debt are amounts owed on our bonds payable, notes payable to banks and others, and noncompete agreements. These borrowings are further explained in Note 8, *Long-term Debt,* of the notes to our consolidated financial statements included in our 2005 Form 10-K.

(b) Interest on our fixed rate debt is presented using the stated interest rate. Interest expense on our variable rate debt is estimated using the rate in effect as of June 30, 2006. Interest related to capital lease obligations is

excluded from this line. Amounts exclude amortization of debt discount, amortization of loans fees, or fees for lines of credit that would be included in interest expense in our consolidated statements of operations. Amounts also exclude the impact of our interest rate swap.

(c) Amounts include interest portion of future minimum capital lease payments.

(d) We lease many of our facilities as well as other property and equipment under operating leases in the normal course of business. Some of our facility leases require percentage rentals on patient revenues above specified minimums and contain escalation clauses. The minimum lease payments do not include contingent rental expense. Some lease agreements provide us with the option to renew the lease or purchase the leased property. Our future operating lease obligations would change if we exercised these renewal options and if we entered into additional operating lease agreements. For more information, see Note 5, *Property and Equipment,* of the notes to our consolidated financial statements included in our 2005 Form 10-K.

(e) Lease obligations for facility closures are included in operating leases.

(f) Future operating lease obligations and purchase obligations are not recognized in our consolidated balance sheet.

(g) Purchase obligations include agreements to purchase goods or services that are enforceable and legally binding on HealthSouth and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase obligations exclude agreements that are cancelable without penalty. Approximately $36.1 million of the amounts included in this line represent commitments on the Digital Hospital. Commitments related to the Digital Hospital are currently under negotiation with various parties and may be less than the amounts reflected in the chart above.

(h) Because their future cash outflows are uncertain, the following non-current liabilities are excluded from the table above: medical malpractice and workers compensation risks, deferred income taxes, and our estimated liability for unsettled litigation. For more information, see Note 1, *Summary of Significant Accounting Policies,* Self-Insured Risk*,* Note 18, *Income Taxes,* and Note 24, *Contingencies and Other Commitments,* of the notes to our consolidated financial statements included in our 2005 Form 10-K.

Critical Accounting Policies

Our discussion and analysis of our results of operations and liquidity and capital resources are based on our condensed consolidated financial statements which have been prepared in accordance with GAAP. In connection with the preparation of our condensed consolidated financial statements, we are required to make assumptions and estimates about future events, and apply judgment that affects the reported amounts of assets, liabilities, revenue, expenses, and the related disclosures. We base our assumptions, estimates and judgments on historical experience, current trends and other factors we believe to be relevant at the time we prepared our condensed consolidated financial statements. On a regular basis, we review the accounting policies, assumptions, estimates and judgments to ensure that our condensed consolidated financial statements are presented fairly and in accordance with GAAP. However, because future events and their effects cannot be determined with certainty, actual results could differ from our assumptions and estimates, and such differences could be material.

Our significant accounting policies are discussed in Note 1, *Summary of Significant Accounting Policies*, to our consolidated financial statements included in our 2005 Form 10-K and Note 1, *Basis of Presentation*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report. Of our significant accounting policies, those that we consider to be the most critical to aid in fully understanding and evaluating our reported financial results, as they require management s most difficult, subjective or complex judgments, resulting from the need to make estimates about the effect of matters that are inherently uncertain, are disclosed in Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations*, Critical Accounting Policies, to our 2005 Form 10-K.

Since the filing of our 2005 Form 10-K, we have adopted one additional critical accounting policy due to the adoption of FASB Statement No. 123(R) on January 1, 2006. FASB Statement No. 123(R) requires all share-based payments, including grants of stock options, to be recognized in the financial statements based on their fair

value. The fair value is estimated at the date of grant using a Black-Scholes option pricing model with weighted-average assumptions for the activity under our stock plans. Option pricing model assumptions such as expected term, expected volatility, risk-free interest rate, and expected dividends, impact the fair value estimate. Further, the forfeiture rate impacts the amount of aggregate compensation. These assumptions are subjective and generally require significant analysis and judgment to develop. When estimating fair value, some of the assumptions will be based on or determined from external data and other assumptions may be derived from our historical experience with share-based payment arrangements. The appropriate weight to place on historical experience is a matter of judgment based on relevant facts and circumstances.

We estimate our expected term through an analysis of actual, historical post-vesting exercise, cancellation, and expiration behavior by our employees and projected post-vesting activity of outstanding options. We currently calculate volatility based on the historical volatility of our common stock over the period commensurate with the expected life of the options, excluding a distinct period of extreme volatility between 2002 and 2003. The risk-free interest rate is the implied daily yield currently available on U.S. Treasury issues with a remaining term closely approximating the expected term used as the input to the Black-Scholes option pricing model. We have never paid cash dividends on our common stock, and we do not anticipate paying cash dividends on our common stock in the foreseeable future. Therefore, we do not include a dividend payment as part of our pricing model. We estimate forfeitures through an analysis of actual, historical pre-vesting option cancellations.

Recent Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. FASB Interpretation No. 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FASB Statement No. 109 does not prescribe a recognition threshold or measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. FASB Interpretation No. 48 clarifies the application of FASB Statement No. 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in a company s financial statements. Additionally, FASB Interpretation No. 48 provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

FASB Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Early adoption is permitted as of the beginning of a company s fiscal year, provided the company has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. As we do not meet the requirements for early adoption, we will adopt FASB Interpretation No. 48 on January 1, 2007. The cumulative effects, if any, of applying this Interpretation will be recorded as an adjustment to *Accumulated deficit* as of January 1, 2007. We are currently evaluating the potential impact of FASB Interpretation No. 48 on our financial position, results of operations, and cash flows.

Since the filing of our 2005 Form 10-K, we do not believe any other recently issued, but not yet effective, accounting standards will have a material effect on our consolidated financial position, results of operations, or cash flows. For additional information regarding recent accounting pronouncements, please see Note 1, *Basis of Presentation*, to our condensed consolidated financial statements included under Part I, Item 1, *Financial Statements (Unaudited)*, of this report.

Cautionary Statement Regarding Forward-Looking Statements

This quarterly report contains historical information, as well as forward-looking statements that involve known and unknown risks and relate to future events, our future financial performance, or our projected business results. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, targets, potential, or

continue or the negative of these terms or other comparable terminology. Such forward-looking statements are necessarily estimates based upon current information and involve a number of risks and uncertainties. Actual events or results may differ materially from the results anticipated in these forward-looking statements as a result of a variety of factors. While it is impossible to identify all such factors, factors that could cause actual results to differ materially from those estimated by us include:

- uncertainties and factors discussed elsewhere in this Form 10-Q, in our other filings with the SEC, or in materials incorporated therein by reference;
- the outcome of continuing investigations by the DOJ and other governmental agencies regarding our financial reporting and related activity;
- the final resolution of pending litigation filed against us, including class action litigation alleging violations of federal securities laws by us;
- our ability to successfully remediate our internal control weaknesses;
- changes or delays in or suspension of reimbursement for our services by governmental or private payors;
- changes in the regulations of the health care industry at either or both of the federal and state levels;
- changes in reimbursement for health care services we provide;
- competitive pressures in the health care industry and our response to those pressures;
- our ability to obtain and retain favorable arrangements with third-party payors;
- our ability to attract and retain nurses, therapists, and other health care professionals in a highly competitive environment with often severe staffing shortages; and
- general conditions in the economy and capital markets.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our primary exposure to market risk is to changes in interest rates on our long-term debt. We use sensitivity analysis models to evaluate the impact of interest rate changes on these items.

Changes in interest rates have different impacts on the fixed and variable rate portions of our debt portfolio. A change in interest rates impacts the net fair value of our fixed rate debt but has no impact on interest expense or cash flows. Interest rate changes on variable rate debt impacts the interest expense and cash flows, but does not impact the net fair value of the underlying debt instruments. Our fixed and variable rate debt as

of June 30, 2006 is shown in the following table:

	As of June 30, 2006			
	Carrying Amount	% of Total	Estimated Fair Value	% of Total
	(In Thousands)			
Fixed rate debt	$ 678,741	21.5%	$ 664,743	21.2%
Variable rate debt	2,475,000	78.5%	2,471,541	78.8%
Total long-term debt	$ 3,153,741	100.0%	$ 3,136,284	100.0%

As discussed in more detail in Note 4, *Long-term Debt*, to our accompanying condensed consolidated financial statements in Part I, Item 1, *Financial Statements (Unaudited)*, in March 2006, we entered into an interest rate swap to effectively convert the floating rate of our Credit Agreement to a fixed rate in order to limit our exposure to variability in interest payments caused by changes in LIBOR. Under the interest rate swap agreement, we pay a fixed rate of 5.2% on $2.0 billion of variable rate debt, while the counterparties to the interest rate swap agreement pay a floating rate based on 3-month LIBOR. As of June 30, 2006, the fair market value of our interest rate swap approximated $16.5 million.

Based on the variable rate of our debt as of June 30, 2006 and inclusive of the impact of the conversion of $2.0 billion of our variable rate debt to a fixed rate via an interest rate swap, a 1% increase in interest rates would result in an additional $4.8 million in interest expense per year, while a 1% decrease in interest rates would reduce interest expense per year by $4.8 million. A 1% increase in interest rates would result in an approximate $35.3 million decrease in the estimated net fair value of our fixed rate debt, and a 1% decrease in interest rates would result in an approximate $36.9 million increase in its estimated net fair value.

Foreign operations, and the related market risks associated with foreign currencies, are currently, and have been, insignificant to our financial position, results of operations, and cash flows.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out by our management, including our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report. This conclusion was based on the fact that the material weaknesses that existed as of December 31, 2005 (as disclosed in our 2005 Form 10-K) were still present at June 30, 2006.

We have undertaken a number of procedures and instituted controls to help ensure the proper collection, evaluation and disclosure of the information included in our financial statements. We have implemented additional analytical tools and verification procedures to address these weaknesses. As a result, we believe that the consolidated financial statements for the periods covered by and included in this Quarterly Report on Form 10-Q are fairly stated in all material respects.

Changes in Internal Control Over Financial Reporting

There have been no material changes in internal control over financial reporting during the quarter ended June 30, 2006. We have engaged in, and are continuing to engage in, substantial efforts to improve our internal control over financial reporting and disclosure controls and procedures related to substantially all areas of our financial statements and disclosures. These remediation efforts are expected to continue throughout 2006 and beyond. We have established a project management office to coordinate all aspects of our remediation program, including the development of detailed plans to eliminate our material weaknesses in internal control over financial reporting and the monitoring of our progress in completing these plans. Our Audit Committee has provided and will continue to provide oversight and review of our initiatives to remediate material weaknesses in our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information relating to certain legal proceedings in which we are involved is included in Note 10, *Settlement*s, and Note 11, *Contingencies*, to the condensed consolidated financial statements contained in Part I, Item 1 of this report and is incorporated herein by reference and should be read in conjunction with the related disclosure previously reported in our 2005 Form 10-K and in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Item 1A, *Risk Factors*, in our 2005 Form 10-K, which could materially affect our business, financial condition, or operating results. The risks described in our 2005 Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, or operating results.

We may be unable to successfully consummate transactions related to our strategic repositioning and, if consummated, the implementation of such transactions could adversely affect us.

On August 14, 2006, we announced that we would explore a range of strategic alternatives to enhance stockholder value and to reposition our focus on the post-acute care sector. These strategic alternatives include, but are not limited to, the spin-off, sale or other disposition of our surgery centers and outpatient rehabilitation divisions, together with our previously announced determination with respect to our diagnostic division. We may be unable to identify and consummate transactions to implement such strategy on appropriate terms, and such failure could have a material adverse effect on our ability to reposition our focus on the post-acute care sector. A change in the economy, industry or financial markets could adversely impact our ability to consummate such transactions. Moreover, if such transactions are consummated, we will need to adapt to the change in our focus in an efficient and cost-effective manner without disruption to our remaining operations. Our failure to implement such changes effectively could have a material adverse effect on our business, financial position, results of operations, and cash flows.

Item 4. Submission of Matters to a Vote of Security Holders

We held our 2006 Annual Meeting of Stockholders on May 18, 2006. At the annual meeting, the stockholders voted on the election of all nine members of our board of directors. The voting results at the annual meeting were as follows:

Proposal One, election of directors, which passed:

Name of Nominee	Votes For	Votes Withheld
Edward A. Blechschmidt	390,770,490	2,635,995
Donald L. Correll	386,543,155	6,863,330
Yvonne M. Curl	384,345,880	9,060,605
Charles M. Elson	390,484,766	2,921,719
Jay Grinney	383,715,465	9,691,020
Jon F. Hanson	386,549,763	6,856,722
Leo I. Higdon, Jr.	390,448,323	2,958,162
John E. Maupin, Jr.	384,400,435	9,006,050
L. Edward Shaw, Jr.	384,939,724	8,466,761

Item 5. Other Events

On June 21, 2006, we announced the resignation of Gregory L. Doody from his positions as Executive Vice President, General Counsel, and Secretary of HealthSouth in order to become general counsel of Calpine Corporation. The employment agreement between HealthSouth and Mr. Doody, the principal terms of which are incorporated herein by reference to and are set forth in Item 11, *Executive Compensation*, of our comprehensive Annual Report on Form 10-K for the years ended December 31, 2003 and 2002, terminated effective July 17, 2006.

On July 26, 2006, we announced the appointment of John P. Whittington as our Interim General Counsel and Corporate Secretary, effective August 1, 2006. Mr. Whittington has been a practicing attorney for almost 35 years and was most recently a partner in the Birmingham, Alabama office of Bradley Arant Rose & White LLP. Prior to joining HealthSouth, Mr. Whittington s practice primarily involved representation of parties in complex business reorganization cases. Since 1990, he has served as adjunct professor at Cumberland School of Law at Samford University and he is a member of the Birmingham Bar Association and the Alabama State Bar, and serves as a co-chair of the ABA sub-committee on Financial Institution Litigation.

Copies of the press releases announcing these matters are attached as Exhibit 99.1 and 99.2, and are incorporated herein by reference.

Item 6. Exhibits

No.	Description
3	By-Laws of HealthSouth Corporation, as amended through May 17, 2001.
4.1	Indenture, dated as of June 14, 2006, among HealthSouth Corporation, the Subsidiary Guarantors (as defined therein) and The Bank of Nova Scotia Trust Company of New York, as trustee, relating to $375,000,000 aggregate principal amount of Floating Rate Senior Notes due 2014 (incorporated by reference to Exhibit 4.1 to HealthSouth s Current Report on Form 8-K filed June 16, 2006).
4.2	Indenture, dated as of June 14, 2006, among HealthSouth Corporation, the Subsidiary Guarantors (as defined therein) and The Bank of Nova Scotia Trust Company of New York, as trustee, relating to $625,000,000 aggregate principal amount of 10.75% Senior Notes due 2016 (incorporated by reference to Exhibit 4.2 to HealthSouth s Current Report on Form 8-K filed June 16, 2006).
4.3	Registration Rights Agreement, dated as of June 14, 2006, among HealthSouth Corporation, the Subsidiary Guarantors (as defined therein) and the Initial Purchasers (as defined therein), relating to the $625,000,000 aggregate principal amount of 10.75% Senior Notes due 2016 and the $375,000,000 aggregate principal amount of Floating Rate Senior Notes due 2014 (incorporated by reference to Exhibit 4.3 to HealthSouth s Current Report on Form 8-K filed June 16, 2006).
10.1	Employment Agreement, dated April 19, 2006, between HealthSouth Corporation and Diane L. Munson.+
10.2	Non-Prosecution Agreement, dated May 17, 2006, between HealthSouth and the United States Department of Justice.
10.3.1	Amended Class Action Settlement Agreement, dated March 6, 2006, with representatives of the plaintiff class relating to the action consolidated on July 2, 2003, captioned IN RE HEALTHSOUTH CORP. ERISA LITIGATION, No. CV-03-BE-1700 (N.D. Ala.) (incorporated by reference to Exhibit 10.5.1 to HealthSouth s Quarterly Report on Form 10-Q filed May 15, 2006).
10.3.2	First Addendum to the Amended Class Action Settlement Agreement, dated April 11, 2006 (incorporated by reference to Exhibit 10.5.2 to HealthSouth s Quarterly Report on Form 10-Q filed May 15, 2006).
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1	Press release of HealthSouth Corporation, dated June 21, 2006.
99.2	Press release of HealthSouth Corporation, dated July 26, 2006.

+ Management contract or compensatory plan or arrangement.

SIGNATURE

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

HEALTHSOUTH CORPORATION

By: /s/ JOHN L. WORKMAN
John L. Workman

Executive Vice President, Chief Financial Officer

and Principal Accounting Officer

Date: August 14, 2006

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