SANGAMO BIOSCIENCES INC
Form 8-K
October 26, 2006

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

FORM 8-K

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

Date of Report (Date of earliest event reported): October 24, 2006

SANGAMO BIOSCIENCES, INC.
(Exact name of registrant specified in its charter)

Delaware	000-30171	68-0359556
(State or other jurisdiction of incorporation)	(Commission File Number)	(I.R.S. Employer Identification No.)

501 Canal Blvd, Suite A100, Richmond, California	94804
(Address of principal executive offices)	(Zip Code)

Registrant's telephone, including area code: (510) 970-6000

(Former name and former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

[ ] Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

[ ] Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

[ ] Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

[ ] Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

ITEM 1.01. ENTRY INTO A MATERIAL DEFINITIVE AGREEMENT.

On October 24, 2006, Sangamo BioSciences, Inc. (the "Company") entered into a Research, Development and Commercialization Agreement (the "Agreement") with Juvenile Diabetes Research Foundation International, a Pennsylvania nonprofit corporation ("JDRF"). Under the Agreement and subject to its terms and conditions, including the Company's achievement of certain milestones associated with the Company's Phase 2 clinical trial of SB-509 for the treatment of diabetic neuropathy, JDRF will pay the Company an aggregate amount up to $3,000,000. Furthermore, the Company is obligated to cover the costs of the Phase 2 trial that are not covered by JDRF's grant.

SB-509 is administered as an injectable formulation of plasmid DNA that encodes a zinc finger protein transcription factor, designed to upregulate the VEGF-A gene. VEGF-A has been demonstrated to have direct neurotrophic and neuroprotective properties. The Company has completed a Phase 1a dose-escalation study and has an ongoing Phase 1b study of SB-509 in subjects with mild to moderate diabetic neuropathy.

Pursuant to the Agreement, the Company is obligated to use commercially reasonable efforts to carry out the Phase 2 trial and, thereafter, to develop and commercialize, a product containing SB-509 for the treatment of diabetes and complications of diabetes. If the Company fails to satisfy such obligations, JDRF may have the right, subject to certain limitations, to obtain an exclusive, sublicensable license, of the intellectual property generated by the Company in the course of the Phase 2 trial, to make and commercialize products containing SB-509 for the treatment of diabetes and complications of diabetes (the "JDRF License"). If JDRF obtains such a license, it is obligated to pay to the Company a percentage of JDRF's revenues on account of product sales and sublicensing arrangements. If JDRF fails to satisfy its obligations to develop and commercialize a product containing SB-509 under the Agreement, then the JDRF License will terminate and the Company will receive a non-exclusive, fully paid license, for any intellectual property developed during JDRF's use of the JDRF License, to research, develop and commercialize products containing SB-509 for the treatment of diabetes and complications of diabetes.

In addition, after the first commercial launch of SB-509 in a major market, JDRF has the right to receive, subject to certain limitations, annual payments from the Company, until such time when the total amount paid to JDRF, including payments made on account of the Company's licensing arrangements, equals three times the amount received by the Company from JDRF. If the Company's aggregate net sales of SB-509 products exceeds specified thresholds in the first 5 years after its first commercial launch in a major market, the Company is required to make certain payments to JDRF, provided that the aggregate amount of such payments shall not exceed two times the amount received by the Company from JDRF.

The Agreement also provides that if the Company licenses its SB-509 program to a third party, the Company will use its best commercial efforts to include in the license agreement certain rights to terminate such license if the third party/licensee fails to develop and commercialize a product containing SB-509 for the treatment of diabetes and complications of diabetes. If the Company actually licenses its SB-509 program to a third party, JDRF has the right to receive, subject to certain limitations, a percentage of the consideration received by the Company from such license.

The Agreement will terminate when no further payments are due or owed by either party under the Agreement, unless earlier terminated by either party upon the uncured material breach of the other party or by JDRF in the event that the FDA substantially changes the additional clinical endpoints in the Phase 2 protocol.

JDRF was founded in 1970 by the parents of children with juvenile diabetes. Since its inception, JDRF has provided more than $1 billion to diabetes research worldwide. More than 80 percent of JDRF's expenditures directly support research and education about such research. JDRF's mission is to find a cure for diabetes and its complications through the support of research.

ITEM 7.01 REGULATION FD DISCLOSURE

On October 26, 2006, the Company issued press releases announcing the transaction described in Item 1.01 above. A copy of the press releases is attached as Exhibit 99.1 hereto and is incorporated herein by reference.

ITEM 9.01. FINANCIAL STATEMENTS AND EXHIBITS.

(d) Exhibits. The following document is filed as exhibits to this report:

99.1 Press Release of Sangamo Biosciences, Inc., dated October 26, 2006

SIGNATURES

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

SANGAMO BIOSCIENCES, INC.

Date: October 26, 2006

By: /s/ Edward O. Lanphier

Name: Edward O. Lanphier
Title: Chief Executive Officer

bsp; **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	Six Months Ended June 30, 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.

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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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