KINDRED HEALTHCARE, INC
Form 10-Q
May 07, 2010


# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

# FORM 10-Q

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

**For the quarterly period ended March 31, 2010**

**OR**

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

**For the transition period from ______ to ______.**

**Commission file number: 001-14057**

# KINDRED HEALTHCARE, INC.

**(Exact name of registrant as specified in its charter)**

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

**(502) 596-7300**

**(Registrant s telephone number, including area code)**

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

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

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

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

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

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

| **Class of Common Stock** | **Outstanding at April 30, 2010** |
|---|---|
| Common stock, $0.25 par value | 39,481,505 shares |

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**KINDRED HEALTHCARE, INC.**

**CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS**

**(Unaudited)**

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

| | Three months ended March 31, 2010 | 2009 |
|---|---|---|
| Revenues | $ 1,089,837 | $ 1,069,474 |
| Salaries, wages and benefits | 627,175 | 615,218 |
| Supplies | 85,886 | 80,336 |
| Rent | 88,319 | 85,201 |
| Other operating expenses | 234,204 | 220,405 |
| Other income | (3,084) | (2,872) |
| Depreciation and amortization | 31,121 | 30,490 |
| Interest expense | 1,307 | 2,478 |
| Investment income | (877) | (1,475) |
| | 1,064,051 | 1,029,781 |
| Income from continuing operations before income taxes | 25,786 | 39,693 |
| Provision for income taxes | 10,631 | 16,352 |
| Income from continuing operations | 15,155 | 23,341 |
| Discontinued operations, net of income taxes: | | |
| Loss from operations | (154) | (581) |
| Loss on divestiture of operations | (137) | |
| Net income | $ 14,864 | $ 22,760 |
| Earnings per common share: | | |
| Basic: | | |
| Income from continuing operations | $ 0.38 | $ 0.60 |
| Discontinued operations: | | |
| Loss from operations | | (0.02) |
| Loss on divestiture of operations | | |
| Net income | $ 0.38 | $ 0.58 |
| Diluted: | | |
| Income from continuing operations | $ 0.38 | $ 0.60 |
| Discontinued operations: | | |
| Loss from operations | | (0.02) |
| Loss on divestiture of operations | | |
| Net income | $ 0.38 | $ 0.58 |
| Shares used in computing earnings per common share: | | |
| Basic | 38,626 | 38,184 |

| | | |
|---|---|---|
| Diluted | 38,859 | 38,315 |

See accompanying notes.

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**KINDRED HEALTHCARE, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEET**

**(Unaudited)**

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

| | March 31, 2010 | December 31, 2009 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 14,675 | $ 16,303 |
| Cash restricted | 6,421 | 5,820 |
| Insurance subsidiary investments | 64,253 | 106,834 |
| Accounts receivable less allowance for loss of $19,053 March 31, 2010 and $20,156 December 31, 2009 | 663,654 | 610,959 |
| Inventories | 22,228 | 22,303 |
| Deferred tax assets | 46,391 | 42,791 |
| Income taxes | | 17,447 |
| Other | 28,252 | 21,194 |
| | 845,874 | 843,651 |
| Property and equipment | 1,580,194 | 1,515,700 |
| Accumulated depreciation | (790,577) | (765,602) |
| | 789,617 | 750,098 |
| Goodwill | 81,382 | 81,223 |
| Intangible assets less accumulated amortization of $2,868 March 31, 2010 and $2,647 December 31, 2009 | 66,489 | 64,491 |
| Assets held for sale | 8,773 | 8,806 |
| Insurance subsidiary investments | 110,028 | 100,223 |
| Deferred tax assets | 114,966 | 110,930 |
| Other | 64,266 | 62,802 |
| | $ 2,081,395 | $ 2,022,224 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 153,969 | $ 161,066 |
| Salaries, wages and other compensation | 266,548 | 287,772 |
| Due to third party payors | 26,589 | 28,261 |
| Professional liability risks | 43,742 | 47,076 |
| Other accrued liabilities | 77,279 | 78,358 |
| Income taxes | 12,189 | |
| Long-term debt due within one year | 87 | 86 |
| | 580,403 | 602,619 |
| Long-term debt | 196,625 | 147,647 |
| Professional liability risks | 207,259 | 195,126 |
| Deferred credits and other liabilities | 114,278 | 110,238 |

| | | |
|---|---|---|
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Common stock, $0.25 par value; authorized 175,000 shares; issued 39,514 shares March 31, 2010 and 39,104 shares December 31, 2009 | 9,878 | 9,776 |
| Capital in excess of par value | 821,638 | 820,407 |
| Accumulated other comprehensive loss | (224) | (423) |
| Retained earnings | 151,538 | 136,834 |
| | 982,830 | 966,594 |
| | $ 2,081,395 | $ 2,022,224 |

See accompanying notes.

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**KINDRED HEALTHCARE, INC.**

**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

**(Unaudited)**

**(In thousands)**

| | Three months ended March 31, 2010 | Three months ended March 31, 2009 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 14,864 | $ 22,760 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 31,121 | 30,805 |
| Amortization of stock-based compensation costs | 2,775 | 2,439 |
| Provision for doubtful accounts | 6,431 | 7,016 |
| Deferred income taxes | (7,463) | (2,179) |
| Loss on divestiture of discontinued operations | 137 | |
| Other | (163) | 204 |
| Change in operating assets and liabilities: | | |
| Accounts receivable | (59,126) | (86,415) |
| Inventories and other assets | (11,245) | (7,535) |
| Accounts payable | (7,582) | (12,264) |
| Income taxes | 29,286 | 43,223 |
| Due to third party payors | (1,894) | 9,401 |
| Other accrued liabilities | (11,137) | (5,535) |
| Net cash provided by (used in) operating activities | (13,996) | 1,920 |
| Cash flows from investing activities: | | |
| Routine capital expenditures | (14,815) | (26,924) |
| Development capital expenditures | (7,567) | (13,062) |
| Acquisitions | (47,696) | (15,604) |
| Purchase of insurance subsidiary investments | (14,278) | (36,257) |
| Sale of insurance subsidiary investments | 53,211 | 54,092 |
| Net change in insurance subsidiary cash and cash equivalents | (5,575) | 20,458 |
| Other | (28) | (953) |
| Net cash used in investing activities | (36,748) | (18,250) |
| Cash flows from financing activities: | | |
| Proceeds from borrowings under revolving credit | 389,600 | 390,800 |
| Repayment of borrowings under revolving credit | (340,600) | (371,600) |
| Payment of deferred financing costs | (22) | (309) |
| Issuance of common stock | 35 | |
| Other | 103 | 94 |
| Net cash provided by financing activities | 49,116 | 18,985 |
| Change in cash and cash equivalents | (1,628) | 2,655 |
| Cash and cash equivalents at beginning of period | 16,303 | 140,795 |
| Cash and cash equivalents at end of period | $ 14,675 | $ 143,450 |

| | | |
|---|---|---|
| Supplemental information: | | |
| Interest payments | $ 875 | $ 2,070 |
| Income tax refunds | 11,412 | 25,170 |

See accompanying notes.

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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1 BASIS OF PRESENTATION**

*Business*

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates hospitals, nursing and rehabilitation centers and a contract rehabilitation services business across the United States (collectively, the Company ). At March 31, 2010, the Company s hospital division operated 83 long-term acute care ( LTAC ) hospitals in 24 states. The Company s nursing center division operated 222 nursing and rehabilitation centers in 27 states. The Company s rehabilitation division provided rehabilitative services primarily in long-term care settings.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at March 31, 2010 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 2 for a summary of discontinued operations.

*Recently issued accounting requirements*

In January 2010, the Financial Accounting Standards Board (the FASB ) issued authoritative guidance related to fair value measurements and disclosures. The provisions of the guidance require new disclosures related to transfers in and out of Levels 1 and 2 (as described in Note 10). The provisions also require a reconciliation of the activity in Level 3 recurring fair value measurements. Existing disclosures also were expanded to include Level 2 fair value measurement valuation techniques and inputs. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2009, except for the disclosures for Level 3 activity which is effective for fiscal years beginning after December 15, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In June 2009, the FASB issued revised authoritative guidance related to the consolidation criteria for variable interest entities ( VIE ). The guidance, among other things, requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a VIE; requires continuous assessments of whether an enterprise is the primary beneficiary of a VIE; enhances disclosures regarding an enterprise s involvement with a VIE; and amends certain guidance for determining whether an entity is a VIE. Under the guidance, a VIE must be consolidated if the enterprise has both (a) the power to direct the activities of the VIE that most significantly impact the entity s economic performance, and (b) the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE. The guidance was effective as of January 1, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

Upon adoption of the VIE guidance on January 1, 2010, the Company reassessed its three investment partnerships and its lease agreements under the new accounting guidance. Although the investment partnerships were determined to be VIEs, they do not require the Company to absorb losses or receive benefits that could potentially be significant to the VIE, nor can the Company direct the activities that most significantly impact the VIEs economic performance. As a result, the investment partnerships continue to be accounted for under the equity method of accounting and are not consolidated. The Company also determined that three of its lease agreements were considered VIEs; however, the Company is not the primary beneficiary as it lacks the power to direct activities of the lessor that most significantly impact economic performance. In addition, the Company s investments and involvement in lease arrangements related to these VIEs were not significant to its accompanying unaudited condensed consolidated financial statements.

**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

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

*Comprehensive income*

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

| | Three months ended March 31, | |
|---|---|---|
| | **2010** | **2009** |
| Net income | $ 14,864 | $ 22,760 |
| Net unrealized investment gains (losses), net of income taxes | 199 | (854) |
| Comprehensive income | $ 15,063 | $ 21,906 |

*Other information*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2009 filed with the Securities and Exchange Commission (the SEC ) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2009 was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

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

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

*Reclassifications*

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

The Company reclassified $1.8 million of book overdrafts for the first quarter of 2009 from net cash used in financing activities to net cash used in operating activities in the accompanying unaudited condensed consolidated statement of cash flows to conform with the current period presentation. The reclassification had no impact on the Company s business, financial position, results of operations or liquidity.

**NOTE 2 DISCONTINUED OPERATIONS**

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestiture of unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the losses related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At March 31, 2010, the Company held for sale one nursing center and two hospitals.

**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 2 DISCONTINUED OPERATIONS (Continued)**

A summary of discontinued operations follows (in thousands):

| | Three months ended March 31, | |
|---|---|---|
| | **2010** | **2009** |
| Revenues | $ 3,802 | $ 16,112 |
| Salaries, wages and benefits | 2,505 | 9,110 |
| Supplies | 210 | 993 |
| Rent | 36 | 1,669 |
| Other operating expenses | 1,327 | 4,971 |
| Depreciation | | 315 |
| Interest expense | | |
| Investment income | (26) | (1) |
| | 4,052 | 17,057 |
| Loss from operations before income taxes | (250) | (945) |
| Income tax benefit | (96) | (364) |
| Loss from operations | (154) | (581) |
| Loss on divestiture of operations, net of income taxes | (137) | |
| | $ (291) | $ (581) |

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

| | Three months ended March 31, | |
|---|---|---|
| | **2010** | **2009** |
| **Revenues:** | | |
| Hospital division | $ 8 | $ 1,063 |
| Nursing center division | 3,794 | 15,049 |
| | $ 3,802 | $ 16,112 |
| **Operating income (loss):** | | |
| Hospital division | $ (817) | $ (850) |
| Nursing center division | 577 | 1,888 |
| | $ (240) | $ 1,038 |

| | | |
|---|---|---|
| **Rent:** | | |
| Hospital division | $ 31 | $ 90 |
| Nursing center division | 5 | 1,579 |
| | $ 36 | $ 1,669 |
| **Depreciation:** | | |
| Hospital division | $ | $ |
| Nursing center division | | 315 |
| | $ | $ 315 |

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

| | **March 31, 2010** | **December 31, 2009** |
|---|---|---|
| Long-term assets: | | |
| Property and equipment, net | $ 8,736 | $ 8,723 |
| Other | 37 | 83 |
| | 8,773 | 8,806 |
| Current liabilities (included in other accrued liabilities) | (330) | (422) |
| | $ 8,443 | $ 8,384 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 3 ACQUISITIONS**

The following is a summary of the Company s significant acquisition activities. The operating results of the acquired businesses have been included in the accompanying unaudited condensed consolidated financial statements of the Company from the respective acquisition dates. The purchase price of the acquired businesses and acquired leased facilities resulted from negotiations with each of the sellers that were based upon both the historical and expected future cash flows of the respective businesses and real estate values. All of these acquisitions were financed through borrowings under the Company s revolving credit facility. Unaudited pro formas related to acquired new businesses have not been presented because the acquisitions are not material, either individually or in the aggregate, to the Company s consolidated financial statements.

In March 2010, the Company acquired a combined nursing and rehabilitation center and assisted living facility for $16.6 million. Goodwill and identifiable intangible assets recorded in connection with the acquisition aggregated $2.4 million.

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

The fair value of each of the acquisitions completed during the first quarter of 2010 were measured using primarily discounted cash flow methodologies which is a Level 3 (as described in Note 10) measurement technique.

In March 2009, the Company acquired the real estate of a previously leased hospital for $15.6 million in cash and $1.6 million in unamortized prepaid rent. Annual rent associated with this facility aggregated $1.8 million. The fair value of the assets acquired were measured using Level 2 observable inputs, including replacement costs and direct sales comparisons of similar properties in the same geographic market or region.

**NOTE 4 REVENUES**

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

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

| | Three months ended March 31, | |
|---|---|---|
| | **2010** | **2009** |
| Medicare | $ 472,472 | $ 462,729 |
| Medicaid | 265,975 | 266,145 |
| Medicare Advantage | 85,904 | 81,256 |
| Other | 342,176 | 329,968 |
| | 1,166,527 | 1,140,098 |
| Eliminations | (76,690) | (70,624) |
| | $ 1,089,837 | $ 1,069,474 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

## NOTE 5 EARNINGS PER SHARE

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

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

| | Three months ended March 31, | | | |
|---|---|---|---|---|
| | 2010 | | 2009 | |
| | Basic | Diluted | Basic | Diluted |
| Earnings: | | | | |
| Income from continuing operations: | | | | |
| As reported in Statement of Operations | $ 15,155 | $ 15,155 | $ 23,341 | $ 23,341 |
| Allocation to participating unvested restricted stockholders | (277) | (275) | (441) | (440) |
| Available to common stockholders | $ 14,878 | $ 14,880 | $ 22,900 | $ 22,901 |
| Discontinued operations, net of income taxes: | | | | |
| Loss from operations: | | | | |
| As reported in Statement of Operations | $ (154) | $ (154) | $ (581) | $ (581) |
| Allocation to participating unvested restricted stockholders | 3 | 3 | 11 | 11 |
| Available to common stockholders | $ (151) | $ (151) | $ (570) | $ (570) |
| Loss on divestiture of operations: | | | | |
| As reported in Statement of Operations | $ (137) | $ (137) | $ | $ |
| Allocation to participating unvested restricted stockholders | 2 | 2 | | |
| Available to common stockholders | $ (135) | $ (135) | $ | $ |
| Net income: | | | | |
| As reported in Statement of Operations | $ 14,864 | $ 14,864 | $ 22,760 | $ 22,760 |
| Allocation to participating unvested restricted stockholders | (272) | (270) | (430) | (429) |
| Available to common stockholders | $ 14,592 | $ 14,594 | $ 22,330 | $ 22,331 |
| Shares used in the computation: | | | | |
| Weighted average shares outstanding basic computation | 38,626 | 38,626 | 38,184 | 38,184 |
| Dilutive effect of employee stock options | | 233 | | 131 |

| | | | | |
|---|---|---|---|---|
| Adjusted weighted average shares outstanding diluted computation | | 38,859 | | 38,315 |
| Earnings per common share: | | | | |
| Income from continuing operations | $ 0.38 | $ 0.38 | $ 0.60 | $ 0.60 |
| Discontinued operations: | | | | |
| Loss from operations | | | (0.02) | (0.02) |
| Loss on divestiture of operations | | | | |
| Net income | $ 0.38 | $ 0.38 | $ 0.58 | $ 0.58 |
| Number of antidilutive stock options excluded from shares used in the diluted earnings per common share computation | | 2,088 | | 3,031 |

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**NOTE 6 BUSINESS SEGMENT DATA**

At March 31, 2010, the Company operated three business segments: the hospital division, the nursing center division and the rehabilitation division. The hospital division operates LTAC hospitals. The nursing center division operates nursing and rehabilitation centers. The rehabilitation division provides rehabilitation services primarily in long-term care settings. For segment purposes, the Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company s business segments excludes the allocation of corporate overhead.

Operating income for the three months ended March 31, 2010 included severance and retirement costs approximating $1.1 million for the hospital division, $0.5 million for the nursing center division and $1.3 million for corporate. Operating income for the three months ended March 31, 2010 also included transaction costs approximating $0.4 million for the hospital division and $0.4 million for the nursing center division.

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

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

| | Three months ended March 31, | |
|---|---|---|
| | 2010 | 2009 |
| **Revenues:** | | |
| Hospital division | $ 507,062 | $ 492,509 |
| Nursing center division | 539,321 | 529,942 |
| Rehabilitation division | 120,144 | 117,647 |
| | 1,166,527 | 1,140,098 |
| Eliminations | (76,690) | (70,624) |
| | $ 1,089,837 | $ 1,069,474 |
| **Income from continuing operations:** | | |
| Operating income (loss): | | |
| Hospital division | $ 95,033 | $ 100,899 |
| Nursing center division | 70,249 | 75,574 |
| Rehabilitation division | 14,635 | 15,453 |
| Corporate: | | |
| Overhead | (33,781) | (34,087) |
| Insurance subsidiary | (480) | (1,452) |
| | (34,261) | (35,539) |
| Operating income | 145,656 | 156,387 |
| Rent | (88,319) | (85,201) |

| | | |
|---|---|---|
| Depreciation and amortization | (31,121) | (30,490) |
| Interest, net | (430) | (1,003) |
| Income from continuing operations before income taxes | 25,786 | 39,693 |
| Provision for income taxes | 10,631 | 16,352 |
| | $ 15,155 | $ 23,341 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 6 BUSINESS SEGMENT DATA (Continued)**

| | Three months ended March 31, 2010 | Three months ended March 31, 2009 |
|---|---|---|
| **Rent:** | | |
| Hospital division | $ 37,415 | $ 36,445 |
| Nursing center division | 49,392 | 47,274 |
| Rehabilitation division | 1,475 | 1,451 |
| Corporate | 37 | 31 |
| | $ 88,319 | $ 85,201 |
| **Depreciation and amortization:** | | |
| Hospital division | $ 13,014 | $ 12,512 |
| Nursing center division | 12,113 | 11,685 |
| Rehabilitation division | 585 | 547 |
| Corporate | 5,409 | 5,746 |
| | $ 31,121 | $ 30,490 |
| **Capital expenditures, excluding acquisitions (including discontinued operations):** | | |
| Hospital division: | | |
| Routine | $ 6,065 | $ 4,844 |
| Development | 5,774 | 9,486 |
| | 11,839 | 14,330 |
| Nursing center division: | | |
| Routine | 4,049 | 18,264 |
| Development | 1,793 | 3,576 |
| | 5,842 | 21,840 |
| Rehabilitation division | 267 | 190 |
| Corporate: | | |
| Information systems | 4,146 | 3,453 |
| Other | 288 | 173 |
| | $ 22,382 | $ 39,986 |

| | March 31, 2010 | December 31, 2009 |
|---|---|---|
| **Assets at end of period:** | | |
| Hospital division | $ 943,603 | $ 867,332 |
| Nursing center division | 584,382 | 566,592 |
| Rehabilitation division | 58,566 | 53,856 |
| Corporate | 494,844 | 534,444 |

| | | |
|---|---|---|
| | $ 2,081,395 | $ 2,022,224 |
| **Goodwill:** | | |
| Hospital division | $ 68,577 | $ 68,577 |
| Nursing center division | 1,048 | 889 |
| Rehabilitation division | 11,757 | 11,757 |
| | $ 81,382 | $ 81,223 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 7 INSURANCE RISKS**

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

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

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

| | Three months ended March 31, | |
|---|---|---|
| | 2010 | 2009 |
| Professional liability: | | |
| Continuing operations | $ 17,270 | $ 14,888 |
| Discontinued operations | (435) | (130) |
| Workers compensation: | | |
| Continuing operations | $ 10,998 | $ 9,846 |
| Discontinued operations | (759) | (847) |

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

| | March 31, 2010 | | | December 31, 2009 | | |
|---|---|---|---|---|---|---|
| | Professional liability | Workers compensation | Total | Professional liability | Workers compensation | Total |
| **Assets:** | | | | | | |
| Current: | | | | | | |
| Insurance subsidiary investments | $ 43,742 | $ 20,511 | $ 64,253 | $ 84,953 | $ 21,881 | $ 106,834 |
| Reinsurance recoverables | 89 | | 89 | 89 | | 89 |
| Other | | 320 | 320 | | 321 | 321 |
| | 43,831 | 20,831 | 64,662 | 85,042 | 22,202 | 107,244 |
| Non-current: | | | | | | |
| Insurance subsidiary investments | 49,903 | 60,125 | 110,028 | 43,272 | 56,951 | 100,223 |
| Reinsurance and other recoverables | 32,745 | 2,328 | 35,073 | 29,446 | 2,030 | 31,476 |
| Deposits | 5,000 | 1,410 | 6,410 | 5,000 | 1,410 | 6,410 |
| Other | | 34 | 34 | | 36 | 36 |
| | 87,648 | 63,897 | 151,545 | 77,718 | 60,427 | 138,145 |

| | | | | | | |
|---|---|---|---|---|---|---|
| | $ 131,479 | $ 84,728 | $ 216,207 | $ 162,760 | $ 82,629 | $ 245,389 |
| **Liabilities:** | | | | | | |
| Allowance for insurance risks: | | | | | | |
| Current | $ 43,742 | $ 22,516 | $ 66,258 | $ 47,076 | $ 23,934 | $ 71,010 |
| Non-current | 207,259 | 60,547 | 267,806 | 195,126 | 58,188 | 253,314 |
| | $ 251,001 | $ 83,063 | $ 334,064 | $ 242,202 | $ 82,122 | $ 324,324 |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 7 INSURANCE RISKS (Continued)**

Provisions for loss for professional liability risks retained by the Company s limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 2% to 5% depending upon the policy year. The discount rate was 2% for the 2010 and 2009 policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $256.0 million at March 31, 2010 and $247.3 million at December 31, 2009.

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

**NOTE 8 INSURANCE SUBSIDIARY INVESTMENTS**

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

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

| | March 31, 2010 | | | | December 31, 2009 | | | |
|---|---|---|---|---|---|---|---|---|
| | Amortized cost | Unrealized gains | Unrealized losses | Fair value | Amortized cost | Unrealized gains | Unrealized losses | Fair value |
| Cash and cash equivalents (a) | $ 101,718 | $ | $ | $ 101,718 | $ 96,143 | $ | $ | $ 96,143 |
| Debt securities: | | | | | | | | |
| Corporate bonds | 37,016 | 659 | (85) | 37,590 | 47,528 | 770 | (102) | 48,196 |
| Debt securities issued by U.S. government agencies | 15,078 | 88 | (12) | 15,154 | 37,788 | 223 | (43) | 37,968 |
| U.S. Treasury notes | 1,251 | 1 | | 1,252 | 2,801 | 19 | | 2,820 |
| Debt securities issued by foreign governments | 624 | 5 | | 629 | 624 | | (5) | 619 |
| Commercial mortgage-backed securities | 591 | 27 | | 618 | 610 | 27 | | 637 |
| | 54,560 | 780 | (97) | 55,243 | 89,351 | 1,039 | (150) | 90,240 |
| Equities by industry: | | | | | | | | |
| Financial services | 1,284 | 217 | (74) | 1,427 | 1,284 | 162 | (155) | 1,291 |
| Healthcare | 1,573 | 20 | (177) | 1,416 | 1,573 | 16 | (171) | 1,418 |
| Oil and gas | 1,104 | 14 | (274) | 844 | 1,257 | 8 | (303) | 962 |
| Real estate | 148 | 2 | (18) | 132 | 147 | 2 | (24) | 125 |
| Other | 8,005 | 242 | (949) | 7,298 | 8,470 | 80 | (1,132) | 7,418 |
| | 12,114 | 495 | (1,492) | 11,117 | 12,731 | 268 | (1,785) | 11,214 |
| Commercial paper | 6,200 | 5 | (2) | 6,203 | 9,449 | 14 | (3) | 9,460 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | $ 174,592 | $ 1,280 | $ (1,591) | $ 174,281 | $ 207,674 | $ 1,321 | $ (1,938) | $ 207,057 |

(a) Includes $0.7 million and $4.7 million of money market funds at March 31, 2010 and December 31, 2009, respectively.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

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

The Company s investment policy governing insurance subsidiary investments precludes the investment portfolio managers from selling any security at a loss without prior authorization from the Company. The investment managers also limit the exposure to any one issue, issuer or type of investment. The Company intends, and has the ability, to hold insurance subsidiary investments for a long duration without the necessity of selling securities to fund the underwriting needs of its insurance subsidiary. This ability to hold securities allows sufficient time for recovery of temporary declines in the market value of equity securities and the par value of debt securities as of their stated maturity date.

The Company considered the severity and duration of its unrealized losses at March 31, 2010 and 2009 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these securities.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $22 million and $34 million during the first quarter of 2010 and 2009, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s revolving credit facility.

**NOTE 9 CONTINGENCIES**

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

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

Principal contingencies are described below:

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

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

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

*Litigation* The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. These legal actions and investigations could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The U.S. Department of Justice (the DOJ ), the Centers for Medicare and Medicaid Services ( CMS ) or other federal and state enforcement and regulatory agencies

**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 9 CONTINGENCIES (Continued)**

may conduct additional investigations related to the Company s businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company s business, financial position, results of operations and liquidity.

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

**NOTE 10 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS**

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

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

**Level 1** Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency asset backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

**Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

**Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 10 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)**

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

| | Fair value measurements Level 1 | Level 2 | Level 3 | Assets/liabilities at fair value | Total losses |
|---|---|---|---|---|---|
| **March 31, 2010:** | | | | | |
| Recurring: | | | | | |
| Assets: | | | | | |
| Available-for-sale debt securities: | | | | | |
| Corporate bonds | $ | $ 37,590 | $ | $ 37,590 | $ |
| Debt securities issued by U.S. government agencies | | 15,154 | | 15,154 | |
| U.S. Treasury notes | 1,252 | | | 1,252 | |
| Debt securities issued by foreign governments | | 629 | | 629 | |
| Commercial mortgage-backed securities | | 618 | | 618 | |
| | 1,252 | 53,991 | | 55,243 | |
| Available-for-sale equity securities | 11,117 | | | 11,117 | |
| Commercial paper | | 6,203 | | 6,203 | |
| Money market funds | 686 | | | 686 | |
| Total available-for-sale investments | 13,055 | 60,194 | | 73,249 | |
| Deposits held in money market funds | 959 | 3,000 | | 3,959 | |
| | $ 14,014 | $ 63,194 | $ | $ 77,208 | $ |
| Liabilities | $ | $ | $ | $ | $ |
| Non-recurring: | | | | | |
| Assets | $ | $ | $ | $ | $ |
| Liabilities | $ | $ | $ | $ | $ |
| **December 31, 2009:** | | | | | |
| Recurring: | | | | | |
| Assets: | | | | | |
| Available-for-sale debt securities: | | | | | |
| Corporate bonds | $ | $ 48,196 | $ | $ 48,196 | $ |
| Debt securities issued by U.S. government agencies | | 37,968 | | 37,968 | |
| U.S. Treasury notes | 2,820 | | | 2,820 | |
| Debt securities issued by foreign governments | | 619 | | 619 | |
| Commercial mortgage-backed securities | | 637 | | 637 | |

| | | | | | |
|---|---|---|---|---|---|
| | 2,820 | 87,420 | | 90,240 | |
| Available-for-sale equity securities | 11,214 | | | 11,214 | |
| Commercial paper | | 9,460 | | 9,460 | |
| Money market funds | 4,692 | | | 4,692 | |
| Total available-for-sale investments | 18,726 | 96,880 | | 115,606 | |
| Deposits held in money market funds | 351 | 3,000 | | 3,351 | |
| | $ 19,077 | $ 99,880 | $ | $ 118,957 | $ |
| Liabilities | $ | $ | $ | $ | $ |
| Non-recurring: | | | | | |
| Assets: | | | | | |
| Acquired previously leased hospital | $ | $ 18,000 | $ | $ 18,000 | $ |
| Nursing centers available for sale | | | 1,000 | 1,000 | (21,870) |
| | $ | $ 18,000 | $ 1,000 | $ 19,000 | $ (21,870) |
| Liabilities | $ | $ | $ | $ | $ |

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**KINDRED HEALTHCARE, INC.**

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

**(Unaudited)**

**NOTE 10 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)**

*Recurring measurements*

The Company s available-for-sale investments are held by its limited purpose insurance subsidiary and are comprised of debt securities, equities, commercial paper and money market funds. These available-for-sale investments and the insurance subsidiary s cash and cash equivalents of $101.0 million as of March 31, 2010 and $91.5 million as of December 31, 2009, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

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

The fair value of actively traded debt and equity securities and money market funds are based upon quoted market prices and are generally classified as Level 1. The fair value of inactively traded debt securities and commercial paper are based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and are generally classified as Level 2. The Company s investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors to ensure prices are reasonable estimates of fair value. Based upon the Company s internal review procedures, there were no adjustments to the prices during the three months ended March 31, 2010 or March 31, 2009.

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

| | March 31, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| **(In thousands)** | **Carrying value** | **Fair value** | **Carrying value** | **Fair value** |
| Cash and cash equivalents | $ 14,675 | $ 14,675 | $ 16,303 | $ 16,303 |
| Cash restricted | 6,421 | 6,421 | 5,820 | 5,820 |
| Insurance subsidiary investments | 174,281 | 174,281 | 207,057 | 207,057 |
| Tax refund escrow investments | 215 | 215 | 215 | 215 |
| Long-term debt, including amounts due within one year | 196,712 | 196,694 | 147,733 | 147,724 |

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

**Cautionary Statement**

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

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

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

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

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

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

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

- failure of the Company s facilities to meet applicable licensure and certification requirements, the further consolidation and cost containment efforts of managed care organizations and other third party payors,

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

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

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

**Cautionary Statement (Continued)**

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

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

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

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

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

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

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

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

the Company s ability to successfully dispose of unprofitable facilities,

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

changes in generally accepted accounting principles or practices, and

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

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

**General**

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

The Company is a healthcare services company that through its subsidiaries operates hospitals, nursing and rehabilitation centers and a contract rehabilitation services business across the United States. At March 31, 2010, the Company s hospital division operated 83 LTAC hospitals (6,580 licensed beds) in 24 states. The Company s nursing center division operated 222 nursing and rehabilitation centers (27,523 licensed beds) in 27 states. The Company s rehabilitation division provided rehabilitative services primarily in long-term care settings.

In recent years, the Company has completed several strategic divestitures to improve its future operating results. For accounting purposes, the operating results of these businesses and the losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at March 31, 2010 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet.

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

**Critical Accounting Policies**

Management s discussion and analysis of financial condition and results of operations are based upon the Company s consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that affect the reported amounts and related disclosures of commitments and contingencies. The Company relies on historical experience and on various other assumptions that management believes to be reasonable under the circumstances to make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

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

*Revenue recognition*

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

*Collectibility of accounts receivable*

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

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

The provision for doubtful accounts totaled $6 million and $7 million for the first quarter of 2010 and 2009, respectively.

*Allowances for insurance risks*

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

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

Provisions for loss for professional liability risks retained by the Company s limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate

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

**Critical Accounting Policies (Continued)**

*Allowances for insurance risks (Continued)*

of 2% to 5% depending upon the policy year. The discount rate was 2% for the 2010 and 2009 policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. The allowance for professional liability risks aggregated $251 million at March 31, 2010 and $242 million at December 31, 2009. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $256 million at March 31, 2010 and $247 million at December 31, 2009.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $22 million and $34 million during the first quarter of 2010 and 2009, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s revolving credit facility.

Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between the Company s estimated and actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. For example, a 1% variance in the allowance for professional liability risks at March 31, 2010 would impact the Company s operating income by approximately $3 million.

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $17 million and $14 million for the first quarter of 2010 and 2009, respectively.

Provisions for loss for workers compensation risks retained by the Company s limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually. The allowance for workers compensation risks aggregated $83 million at March 31, 2010 and $82 million at December 31, 2009. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $11 million and $10 million for the first quarter of 2010 and 2009, respectively.

*Accounting for income taxes*

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

The Company s effective income tax rate was 41.2% in the first quarter of both 2010 and 2009.

There are significant uncertainties with respect to capital loss carryforwards that could affect materially the realization of certain deferred tax assets. Accordingly, the Company has recognized deferred tax assets to the extent it is more likely than not they will be realized and a valuation allowance is provided for deferred tax assets

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

**Critical Accounting Policies (Continued)**

*Accounting for income taxes (Continued)*

to the extent that it is uncertain that the deferred tax asset will be realized. The Company recognized net deferred tax assets totaling $161 million at March 31, 2010 and $154 million at December 31, 2009.

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

*Valuation of long-lived assets and goodwill*

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

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

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

In accordance with the authoritative guidance for goodwill and other intangible assets, the Company is required to perform an impairment test for goodwill and indefinite lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. The Company performs its annual goodwill impairment test at the end of each fiscal year for each of its reporting units. A reporting unit is either an operating segment or one level below the operating segment, referred to as a component. When the components within the Company s operating segments have similar economic characteristics, the Company aggregates the components of its operating segments into one reporting unit. Accordingly, the Company has determined that its reporting units are hospitals, nursing centers, rehabilitation services and hospice. The carrying value of goodwill for each of our reporting units at March 31, 2010 and December 31, 2009 follows (in thousands):

| | March 31, 2010 | December 31, 2009 |
|---|---|---|
| Hospitals | $ 68,577 | $ 68,577 |
| Nursing centers | 1,048 | 889 |
| Rehabilitation services | 3,363 | 3,363 |
| Hospice | 8,394 | 8,394 |
| | $ 81,382 | $ 81,223 |

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

**Critical Accounting Policies (Continued)**

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

The goodwill impairment test involves a two-step process. The first step is a comparison of each reporting unit s fair value to its carrying value. If the carrying value of the reporting unit is greater than its fair value, there is an indication that impairment may exist and the second step must be performed to measure the amount of impairment loss. Based upon the results of the step one impairment test for goodwill and the impairment test of indefinite lived intangible assets, no impairment charges were recorded in connection with the Company s annual impairment tests at December 31, 2009. The Company did not believe that any of its reporting units were at risk for failing the step one impairment test at December 31, 2009.

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

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

The Company has determined that during the first quarter of 2010 there were no events or changes in circumstances since December 31, 2009 requiring an interim impairment test. Although the Company has determined that there was no goodwill or other indefinite lived intangible asset impairments as of March 31, 2010 and December 31, 2009, adverse changes in the operating environment and related key assumptions used to determine the fair value of the Company s reporting units and indefinite lived intangible assets or declines in the value of the Company s common stock may result in future impairment charges for a portion or all of these assets. Specifically, if the rate of growth of government and commercial revenues earned by the Company s reporting units were to be less than projected or if healthcare reforms were to negatively impact our business, an impairment charge for a portion or all of the assets may be required. An impairment charge could have a material adverse effect on the Company s business, financial position and results of operations, but would not be expected to have an impact on the Company s cash flows or liquidity.

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

**Recently Issued Accounting Requirements**

In January 2010, the FASB issued authoritative guidance related to fair value measurements and disclosures. The provisions of the guidance require new disclosures related to transfers in and out of Levels 1 and 2 (as described in Note 10). The provisions also require a reconciliation of the activity in Level 3 recurring fair value measurements. Existing disclosures also were expanded to include Level 2 fair value measurement valuation techniques and inputs. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2009, except for the disclosures for Level 3 activity which is effective for fiscal years beginning after December 15, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In June 2009, the FASB issued revised authoritative guidance related to the consolidation criteria for VIEs. The guidance, among other things, requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a VIE; requires continuous assessments of whether an enterprise is the primary beneficiary of a VIE; enhances disclosures regarding an enterprise s involvement with a VIE; and amends certain guidance for determining whether an entity is a VIE. Under the guidance, a VIE must be consolidated if the enterprise has both (a) the power to direct the activities of the VIE that most significantly impact the entity s economic performance, and (b) the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE. The guidance was effective as of January 1, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

Upon adoption of the VIE guidance on January 1, 2010, the Company reassessed its three investment partnerships and its lease agreements under the new accounting guidance. Although the investment partnerships were determined to be VIEs, they do not require the Company to absorb losses or receive benefits that could potentially be significant to the VIE, nor can the Company direct the activities that most significantly impact the VIEs economic performance. As a result, the investment partnerships continue to be accounted for under the equity method of accounting and are not consolidated. The Company also determined that three of its lease agreements were considered VIEs; however, the Company is not the primary beneficiary as it lacks the power to direct activities of the lessor that most significantly impact economic performance. In addition, the Company s investments and involvement in lease arrangements related to these VIEs were not significant to its accompanying unaudited condensed consolidated financial statements.

**Results of Operations Continuing Operations**

***Hospital division***

Revenues increased 3% in the first quarter of 2010 to $507 million compared to $493 million in the first quarter of 2009, primarily as a result of increased admissions and the development of new hospitals. Aggregate reported and same-facility admissions increased 3% in the first quarter of 2010 compared to the first quarter of 2009. Commercial same-facility admissions rose 12% in the first quarter of 2010 compared to the first quarter of 2009.

Hospital operating margins declined in the first quarter of 2010 as increased costs, particularly wage and benefit costs, exceeded the growth in overall revenues. Operating results for the first quarter of 2010 included approximately $2 million related to severance and transaction costs.

Hospital wage and benefit costs increased 4% to $228 million in the first quarter of 2010 from $218 million in the first quarter of 2009. Average hourly wage rates grew 1% in the first quarter of 2010 compared to the first quarter of 2009, while employee benefit costs increased 2% in the first quarter of 2010 compared to the same period last year.

Professional liability costs were $8 million and $6 million in the first quarter of 2010 and 2009, respectively.

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

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

***Nursing center division***

Revenues increased 2% in the first quarter of 2010 to $539 million compared to $530 million in the first quarter of 2009. Revenue growth in the first quarter was primarily attributable to reimbursement rate increases that reflected both inflationary adjustments and higher average patient acuity. Aggregate admissions grew 5% in the first quarter of 2010 compared to the first quarter of 2009. Aggregate patient days declined 1% in the first quarter of 2010 compared to the first quarter of 2009. Medicare patient days declined 2% while Medicare Advantage, private and other patient days were relatively unchanged in the first quarter of 2010 compared to the first quarter of 2009.

Nursing center operating margins declined in the first quarter of 2010 compared to the first quarter of 2009 primarily as a result of 8% growth in ancillary expenses such as rehabilitation, pharmacy and outside services consistent with higher patient acuity levels. Operating results for the first quarter of 2010 included approximately $1 million related to severance and transaction costs.

Nursing center wage and benefit costs were relatively unchanged in the first quarter of 2010 compared to the first quarter of 2009. Average hourly wage rates grew 2% in the first quarter of 2010 compared to the first quarter of 2009, while employee benefit costs were relatively unchanged in the first quarter of 2010 compared to the same period last year.

Professional liability costs were $8 million in the first quarter of both 2010 and 2009.

***Rehabilitation division***

Revenues increased 2% in the first quarter of 2010 to $120 million compared to $117 million in the first quarter of 2009, primarily attributable to growth in the volume of services provided to existing customers. Revenues derived from unaffiliated customers aggregated $44 million and $45 million in the first quarter of 2010 and 2009, respectively.

Operating margins declined in the first quarter of 2010 compared to the first quarter of 2009 as growth in operating expenses exceeded revenue growth for the period. Revenue growth was slowed during the first quarter of 2010 as a result of pricing pressures associated with lower Medicare reimbursement growth rates experienced by existing customers.

***Corporate overhead***

Operating income for the Company s operating divisions excludes allocations of corporate overhead. These costs aggregated $34 million in the first quarter of both 2010 and 2009. As a percentage of consolidated revenues, corporate overhead totaled 3.1% and 3.2% in the first quarter of 2010 and 2009, respectively. Operating results for the first quarter of 2010 included approximately $1 million related to retirement costs.

Corporate expenses included operating losses from the Company s limited purpose insurance subsidiary of $0.4 million in the first quarter of 2010 compared to $1 million in the first quarter of 2009.

***Capital costs***

Rent expense increased 4% to $89 million in the first quarter of 2010 compared to $85 million in the first quarter of 2009, primarily from contractual inflation and contingent rent increases.

Depreciation and amortization expense increased 2% in the first quarter of 2010 to $31 million compared to $30 million in the first quarter of 2009, primarily a result of the Company s ongoing capital expenditure program and hospital development.

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

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

***Capital costs (Continued)***

Interest expense declined to $1 million in the first quarter of 2010 from $2 million in the first quarter of 2009, primarily attributable to lower interest rates and lower borrowing levels under the Company s revolving credit facility compared to the first quarter of 2009.

Investment income related primarily to the Company s insurance subsidiary investments totaled $1 million in the first quarter of both 2010 and 2009. The Company considered the unrealized losses related to its insurance subsidiary investments at March 31, 2010 and 2009 to be temporary and did not record any impairment losses related to these investments in either period.

***Consolidated results***

Income from continuing operations before income taxes decreased 35% to $26 million in the first quarter of 2010 compared to $40 million in the first quarter of 2009. Income from continuing operations decreased 35% to $15 million in the first quarter of 2010 compared to $24 million in the first quarter of 2009.

**Results of Operations Discontinued Operations**

Loss from discontinued operations aggregated $0.2 million in the first quarter of 2010 compared to $0.5 million in the first quarter of 2009.

The Company recorded a pretax loss of $0.2 million ($0.1 million net of income taxes) in the first quarter of 2010 related to the planned divestiture of discontinued operations.

**Liquidity**

***Operating cash flows***

Cash flows used in operations (including discontinued operations) aggregated $14 million in the first quarter of 2010 compared to cash flows provided by operations of $2 million in the first quarter of 2009. Operating cash flows in both periods were negatively impacted by the growth in accounts receivable. Operating cash flows in both periods were favorably impacted by federal income tax refunds of $10 million and $25 million for the first quarter of 2010 and 2009, respectively.

Cash and cash equivalents totaled $15 million at March 31, 2010 compared to $16 million at December 31, 2009. The Company s long-term debt, comprised principally of borrowings under the Company s revolving credit facility, aggregated $197 million at March 31, 2010 compared to $148 million at December 31, 2009. Based upon the Company s existing cash levels, expected operating cash flows and the availability of borrowings under the Company s revolving credit facility ($304 million at March 31, 2010), management believes that the Company has the necessary financial resources to satisfy its expected short-term and long-term liquidity needs.

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

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

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

**Liquidity (Continued)**

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

Interest rates under the Company s revolving credit facility are based, at the Company s option, upon (a) the London Interbank Offered Rate ( LIBOR ) plus the applicable margin or (b) the applicable margin plus the higher of the prime rate or 0.5% over the federal funds rate. The Company s revolving credit facility is collateralized by substantially all of the Company s assets including certain owned real property and is guaranteed by substantially all of the Company s subsidiaries. The terms of the Company s revolving credit facility include a certain defined fixed payment ratio covenant and covenants which limit acquisitions and annual capital expenditures. The Company was in compliance with the terms of its revolving credit facility at March 31, 2010.

Despite the recent instability within the financial markets both nationally and globally, the Company has not experienced any individual lender limitations to extend credit under its revolving credit facility. However, the obligations of each of the lending institutions in the Company s revolving credit facility are separate and the availability of future borrowings under the Company s revolving credit facility could be impacted by further volatility and disruptions in the financial credit markets or other events, including bankruptcy of a lending institution.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $22 million and $34 million during the first quarter of 2010 and 2009, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s revolving credit facility.

**Capital Resources**

Excluding acquisitions, routine capital expenditures totaled $15 million in the first quarter of 2010 compared to $27 million in the first quarter of 2009. Hospital development capital expenditures totaled $5 million in the first quarter of 2010 compared to $9 million in the first quarter of 2009. Nursing center development capital expenditures totaled $2 million in the first quarter of 2010 compared to $4 million in the first quarter of 2009. Excluding acquisitions, the Company anticipates that routine capital expenditures in 2010 will approximate $115 million to $120 million, hospital development capital expenditures should approximate $45 million to $50 million and nursing center development capital expenditures related to transitional care centers and units should approximate $25 million to $30 million. Management believes that its capital expenditure program is adequate to improve and equip existing facilities. The Company s capital expenditure program is financed generally through the use of internally generated funds. At March 31, 2010, the estimated cost to complete and equip construction in progress approximated $61 million.

In March 2010, the Company acquired a combined nursing and rehabilitation center and assisted living facility for approximately $17 million. This transaction was financed through borrowings under the Company s revolving credit facility.

In January 2010, the Company acquired the real estate of two previously leased hospitals and two previously leased nursing and rehabilitation centers for approximately $31 million in cash and approximately $2 million in unamortized prepaid rent. Annual rents associated with these four facilities approximated $3 million. These transactions were financed through borrowings under the Company s revolving credit facility.

In March 2009, the Company acquired the real estate of a previously leased hospital for approximately $16 million in cash and approximately $2 million in unamortized prepaid rent. Annual rent associated with this facility approximated $2 million. This transaction was financed through borrowings under the Company s revolving credit facility.

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

**Other Information**

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

The Company derives a substantial portion of its revenues from the Medicare and Medicaid programs. Congress and certain state legislatures have enacted or may enact additional significant cost containment measures limiting the Company s ability to recover its cost increases through increased pricing of its healthcare services. Medicare revenues in LTAC hospitals and nursing centers are subject to fixed payments under the Medicare prospective payment systems.

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

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

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

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

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

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

(1) a mandated study by the Secretary of Health and Human Services on the establishment of LTAC hospital certification criteria;

(2) enhanced medical necessity review of LTAC hospital cases;

(3) a three-year moratorium on the establishment of a LTAC hospital or satellite facility, subject to exceptions for facilities under development;

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

**Other Information (Continued)**

***Effects of inflation and changing prices (Continued)***

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

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

(6) a three-year moratorium on very short-stay outlier payment reductions to LTAC hospitals initially implemented on May 1, 2007;

(7) a three-year moratorium on the application of the 25 Percent Rule to freestanding LTAC hospitals;

(8) a three-year period during which LTAC hospitals that are co-located with another hospital may admit up to 50% of their patients from their co-located hospital and still be paid according to LTAC PPS;

(9) a three-year period during which LTAC hospitals that are co-located with an urban single hospital or a hospital that generates more than 25% of the Medicare discharges in a metropolitan statistical area ( MSA Dominant hospital ) may admit up to 75% of their patients from such urban single hospital or MSA Dominant hospital and still be paid according to LTAC PPS; and

(10) the elimination of the July 1, 2007 market basket increase in the standard federal payment rate of 0.71%, effective for discharges occurring on or after April 1, 2008.

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

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2007 Final Rule ). In the 2007 Final Rule, the policy known as the 25 Percent Rule (described below) was expanded to all LTAC hospitals, regardless of whether they are co-located with another hospital. Under the 2007 Final Rule, all LTAC hospitals were to be paid LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Patients reaching high cost outlier status in the short-term hospital were not to be counted when computing the 25% limit. Admissions beyond the 25% threshold were to be paid at a lower amount based upon short-term acute care hospital rates. However, as set forth above, the SCHIP Extension Act initially placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. That moratorium was extended to five years by the PPACA. In addition, the SCHIP Extension Act initially provided for a three-year period during which (1) LTAC hospitals may admit up to 50% of their patients from their co-located hospitals and still be paid according to LTAC PPS; and (2) LTAC hospitals that are co-located with an urban single hospital or a MSA Dominant hospital may admit up to 75% of their patients from such urban single or MSA Dominant hospital and still be paid according to LTAC PPS. Those periods also were extended to five years under the PPACA. The five-year moratorium of the 25 Percent Rule threshold payment adjustment for freestanding hospitals and grandfathered hospitals with a host hospital ( HIH ) will expire for cost reporting periods beginning on or after July 1,

2012. The expansion of the admission limit to 50% for non-grandfathered, LTAC hospitals from their co-located hospital will expire for cost reports beginning on or after October 1, 2012, the same time at which the 75% limit for MSA Dominant hospitals will expire.

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

**Other Information (Continued)**

***Effects of inflation and changing prices (Continued)***

On May 2, 2008, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2008 Final Rule ) that became effective for discharges occurring on or after July 1, 2008. The 2008 Final Rule projected an overall increase in payments to all Medicare certified LTAC hospitals of approximately 2.5%. Included in the 2008 Final Rule were (1) an increase to the standard federal payment rate of 2.7% (as compared to the adjusted federal rate for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act); (2) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.1%; (3) an increase in the high cost outlier threshold per discharge to $22,960; and (4) an extension of the rate year cycle for one year to September 30, 2009, in order to be consistent thereafter with the federal fiscal year that begins October 1 of each year.

On April 19, 2010, CMS issued proposed regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2010. Included in those proposed regulations is (1) a market basket increase to the standard federal payment rate of 2.4%; (2) an offset of 2.5% applied to the standard federal payment rate to account for the effect of documentation and coding changes; (3) adjustments to area wage indexes; and (4) an increase in the high cost outlier threshold per discharge to $18,692. CMS has projected the impact of these proposed changes to LTAC PPS to be an increase in payments of 0.8%.

CMS has regulations governing payments to LTAC hospitals that are co-located with another hospital, such as a HIH. The rules generally limit Medicare payments to the HIH if the Medicare admissions to the HIH from its co-located hospital exceed 25% of the total Medicare discharges for the HIH s cost reporting period, the 25 Percent Rule. There are limited exceptions for admissions from rural, urban single and MSA Dominant hospitals. Admissions that exceed this 25 Percent Rule are paid using the short-term acute care inpatient payment system ( IPPS ). Patients transferred after they have reached the short-term acute care outlier payment status are not counted toward the admission threshold. Patients admitted prior to meeting the admission threshold, as well as Medicare patients admitted from a non co-located hospital, are eligible for the full payment under LTAC PPS. If the HIH s admissions from the co-located hospital exceed the limit in a cost reporting period, Medicare will pay the lesser of (1) the amount payable under LTAC PPS; or (2) the amount payable under IPPS. At March 31, 2010, the Company operated 15 HIHs with 633 licensed beds.

On August 1, 2007, CMS issued final regulations regarding Medicare hospital inpatient payments to short-term acute care hospitals as well as certain provisions affecting LTAC hospitals. These regulations adopt a new system for LTAC hospitals for classifying patients into diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, MS-LTC-DRGs. LTAC PPS is based upon discharged-based MS-LTC-DRGs similar to the system used to pay short-term acute care hospitals. This new MS-LTC-DRG system replaced the previous diagnostic related group system for LTAC hospitals and became effective for discharges occurring on or after October 1, 2007. The MS-LTC-DRG system created additional severity-adjusted categories for most diagnoses.

On July 31, 2008, CMS issued final regulations regarding the re-weighting of MS-LTC-DRGs for discharges occurring on or after October 1, 2008. CMS announced that this update was made in a budget neutral manner, and that estimated aggregate LTAC Medicare payments would be unaffected by these regulations. Based upon the Company s experience under these final regulations, it appears that the re-weighting increased payments for the care of higher acuity patients.

On May 29, 2009, CMS issued an interim final rule that revised the October 1, 2008 payment weights. Effective June 3, 2009, CMS reduced MS-LTC-DRG payment weights by 3.9%, resulting in approximately a

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

**Other Information (Continued)**

***Effects of inflation and changing prices (Continued)***

0.9% reduction of the estimated total LTAC PPS payments in the federal fiscal year ending September 30, 2009. No retroactive adjustments to payments were made. On July 31, 2009, CMS finalized this interim rule.

On July 31, 2009, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2009. These final regulations include a recalibration of the MS-LTC-DRG payment weights as well as updates to the payment rates. CMS indicated that these changes will result in a 3.3% increase to average Medicare payments to LTAC hospitals. The 2.7% annualized reduction that resulted from a recalibration of MS-LTC-DRG payment weights on June 3, 2009 is incorporated into the final October 1, 2009 payment weights.

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

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

In addition, for the fiscal year beginning October 1, 2010, CMS finalized provisions that would increase the number of RUG categories for nursing centers from 53 to 66 (i.e., RUGs IV) and amend the criteria, including the provision of therapy services, currently used to classify patients into these categories. CMS has indicated that these changes will be enacted in a budget neutral manner. However, the PPACA enacted a delay in the implementation of RUGs IV until October 1, 2011, while maintaining the provisions related to concurrent therapy and look-back periods set forth in the July 31, 2009 final payment rule. These changes may impair the ability of CMS to implement the changes finalized on July 31, 2009 in a budget neutral manner. While the Company is unable to estimate the impact of these changes, the operating results of its contract rehabilitation services business may be adversely affected.

Medicare Part B provides reimbursement for certain physician services, limited drug coverage and other outpatient services, such as therapy and other services, outside of a Medicare Part A covered patient stay. Since 2006, federal legislation has provided for an annual Medicare Part B outpatient therapy cap. In succeeding years, CMS subsequently increased the amount of the therapy cap. Legislation also was passed that required CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. Legislation has annually extended the Medicare Part B outpatient therapy cap. The Medicare Improvements for Patients and Providers Act of 2008, enacted on July 15, 2008, extended the therapy cap exception process from July 1, 2008 to December 31, 2009. The PPACA provided that the exception process remain in effect from January 1, 2010 through December 31, 2010.

The Company believes that its operating margins may continue to be under pressure as the growth in operating expenses, particularly professional liability, labor and employee benefits costs, exceeds payment increases from third party payors. In addition, as a result of competitive pressures, the Company s ability to maintain operating margins through price increases to private patients is limited.

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

**Condensed Consolidated Statement of Operations**

**(Unaudited)**

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

| | 2009 Quarters | | | | | First Quarter |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | Year | 2010 |
| Revenues | $ 1,069,474 | $ 1,073,054 | $ 1,057,488 | $ 1,069,991 | $ 4,270,007 | $ 1,089,837 |
| Salaries, wages and benefits | 615,218 | 620,830 | 629,077 | 617,961 | 2,483,086 | 627,175 |
| Supplies | 80,336 | 83,912 | 82,400 | 86,408 | 333,056 | 85,886 |
| Rent | 85,201 | 86,882 | 88,081 | 88,084 | 348,248 | 88,319 |
| Other operating expenses | 220,405 | 221,755 | 221,524 | 222,521 | 886,205 | 234,204 |
| Other income | (2,872) | (2,823) | (2,870) | (2,947) | (11,512) | (3,084) |
| Depreciation and amortization | 30,490 | 31,355 | 31,992 | 31,893 | 125,730 | 31,121 |
| Interest expense | 2,478 | 2,229 | 1,741 | 1,432 | 7,880 | 1,307 |
| Investment income | (1,475) | (1,033) | (746) | (1,159) | (4,413) | (877) |
| | 1,029,781 | 1,043,107 | 1,051,199 | 1,044,193 | 4,168,280 | 1,064,051 |
| Income from continuing operations before income taxes | 39,693 | 29,947 | 6,289 | 25,798 | 101,727 | 25,786 |
| Provision for income taxes | 16,352 | 12,409 | 901 | 9,453 | 39,115 | 10,631 |
| Income from continuing operations | 23,341 | 17,538 | 5,388 | 16,345 | 62,612 | 15,155 |
| Discontinued operations, net of income taxes: | | | | | | |
| Income (loss) from operations | (581) | (897) | 13 | 2,396 | 931 | (154) |
| Gain (loss) on divestiture of operations | | (24,051) | 52 | 567 | (23,432) | (137) |
| Net income (loss) | $ 22,760 | $ (7,410) | $ 5,453 | $ 19,308 | $ 40,111 | $ 14,864 |
| Earnings (loss) per common share: | | | | | | |
| Basic: | | | | | | |
| Income from continuing operations | $ 0.60 | $ 0.45 | $ 0.14 | $ 0.42 | $ 1.61 | $ 0.38 |
| Discontinued operations: | | | | | | |
| Income (loss) from operations | (0.02) | (0.02) | | 0.06 | 0.02 | |
| Gain (loss) on divestiture of operations | | (0.62) | | 0.01 | (0.60) | |
| Net income (loss) | $ 0.58 | $ (0.19) | $ 0.14 | $ 0.49 | $ 1.03 | $ 0.38 |
| Diluted: | | | | | | |
| Income from continuing operations | $ 0.60 | $ 0.45 | $ 0.14 | $ 0.42 | $ 1.60 | $ 0.38 |
| Discontinued operations: | | | | | | |
| Income (loss) from operations | (0.02) | (0.02) | | 0.06 | 0.02 | |
| Gain (loss) on divestiture of operations | | (0.62) | | 0.01 | (0.60) | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Net income (loss) | $ 0.58 | $ (0.19) | $ 0.14 | $ 0.49 | $ 1.02 | $ 0.38 |
| Shares used in computing earnings (loss) per common share: | | | | | | |
| Basic | 38,184 | 38,307 | 38,398 | 38,465 | 38,339 | 38,626 |
| Diluted | 38,315 | 38,415 | 38,524 | 38,693 | 38,502 | 38,859 |

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

**Operating Data**

**(Unaudited)**

**(In thousands)**

| | 2009 Quarters | | | | | First Quarter |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | Year | 2010 |
| **Revenues:** | | | | | | |
| Hospital division | $ 492,509 | $ 487,145 | $ 468,069 | $ 485,169 | $ 1,932,892 | $ 507,062 |
| Nursing center division | 529,942 | 537,545 | 539,217 | 543,638 | 2,150,342 | 539,321 |
| Rehabilitation division | 117,647 | 120,450 | 122,625 | 114,316 | 475,038 | 120,144 |
| | 1,140,098 | 1,145,140 | 1,129,911 | 1,143,123 | 4,558,272 | 1,166,527 |
| Eliminations | (70,624) | (72,086) | (72,423) | (73,132) | (288,265) | (76,690) |
| | $ 1,069,474 | $ 1,073,054 | $ 1,057,488 | $ 1,069,991 | $ 4,270,007 | $ 1,089,837 |
| **Income from continuing operations:** | | | | | | |
| Operating income (loss): | | | | | | |
| Hospital division | $ 100,899 | $ 91,027 | $ 78,674 | $ 93,211 | $ 363,811 | $ 95,033(a,b) |
| Nursing center division | 75,574 | 79,522 | 73,383 | 77,111 | 305,590 | 70,249(a,b) |
| Rehabilitation division | 15,453 | 13,599 | 10,912 | 10,628 | 50,592 | 14,635 |
| Corporate: | | | | | | |
| Overhead | (34,087) | (33,586) | (33,843) | (33,120) | (134,636) | (33,781)(a) |
| Insurance subsidiary | (1,452) | (1,182) | (1,769) | (1,782) | (6,185) | (480) |
| | (35,539) | (34,768) | (35,612) | (34,902) | (140,821) | (34,261) |
| Operating income | 156,387 | 149,380 | 127,357 | 146,048 | 579,172 | 145,656 |
| Rent | (85,201) | (86,882) | (88,081) | (88,084) | (348,248) | (88,319) |
| Depreciation and amortization | (30,490) | (31,355) | (31,992) | (31,893) | (125,730) | (31,121) |
| Interest, net | (1,003) | (1,196) | (995) | (273) | (3,467) | (430) |
| Income from continuing operations before income taxes | 39,693 | 29,947 | 6,289 | 25,798 | 101,727 | 25,786 |
| Provision for income taxes | 16,352 | 12,409 | 901 | 9,453 | 39,115 | 10,631 |
| | $ 23,341 | $ 17,538 | $ 5,388 | $ 16,345 | $ 62,612 | $ 15,155 |

(a) Includes severance and retirement costs approximating $1.1 million for the hospital division, $0.5 million for the nursing center division and $1.3 million for corporate.
(b) Includes transaction costs approximating $0.4 million for the hospital division and $0.4 million for the nursing center division.

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

**Operating Data (Continued)**

**(Unaudited)**

**(In thousands)**

| | 2009 Quarters | | | | | First Quarter 2010 |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | Year | |
| **Rent:** | | | | | | |
| Hospital division | $ 36,445 | $ 36,834 | $ 37,062 | $ 37,153 | $ 147,494 | $ 37,415 |
| Nursing center division | 47,274 | 48,565 | 49,471 | 49,525 | 194,835 | 49,392 |
| Rehabilitation division | 1,451 | 1,459 | 1,495 | 1,373 | 5,778 | 1,475 |
| Corporate | 31 | 24 | 53 | 33 | 141 | 37 |
| | $ 85,201 | $ 86,882 | $ 88,081 | $ 88,084 | $ 348,248 | $ 88,319 |
| **Depreciation and amortization:** | | | | | | |
| Hospital division | $ 12,512 | $ 13,018 | $ 13,275 | $ 13,127 | $ 51,932 | $ 13,014 |
| Nursing center division | 11,685 | 12,038 | 12,408 | 12,500 | 48,631 | 12,113 |
| Rehabilitation division | 547 | 549 | 584 | 611 | 2,291 | 585 |
| Corporate | 5,746 | 5,750 | 5,725 | 5,655 | 22,876 | 5,409 |
| | $ 30,490 | $ 31,355 | $ 31,992 | $ 31,893 | $ 125,730 | $ 31,121 |
| **Capital expenditures, excluding acquisitions (including discontinued operations):** | | | | | | |
| Hospital division: | | | | | | |
| Routine | $ 4,844 | $ 5,335 | $ 10,226 | $ 6,311 | $ 26,716 | $ 6,065 |
| Development | 9,486 | 12,395 | 10,884 | 9,606 | 42,371 | 5,774 |
| | 14,330 | 17,730 | 21,110 | 15,917 | 69,087 | 11,839 |
| Nursing center division: | | | | | | |
| Routine | 18,264 | 10,495 | 5,774 | 5,130 | 39,663 | 4,049 |
| Development | 3,576 | 1,451 | 597 | 63 | 5,687 | 1,793 |
| | 21,840 | 11,946 | 6,371 | 5,193 | 45,350 | 5,842 |
| Rehabilitation division | 190 | 172 | 269 | 412 | 1,043 | 267 |
| Corporate: | | | | | | |
| Information systems | 3,453 | 8,838 | 6,152 | 9,998 | 28,441 | 4,146 |
| Other | 173 | 210 | 73 | 1,231 | 1,687 | 288 |
| | $ 39,986 | $ 38,896 | $ 33,975 | $ 32,751 | $ 145,608 | $ 22,382 |

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

**Condensed Consolidating Statement of Operations**

**(Unaudited)**

**(In thousands)**

| | First Quarter 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Hospital division | Nursing center division | Rehabilitation division | Corporate | Eliminations | Consolidated |
| Revenues | $ 507,062 | $ 539,321 | $ 120,144 | $ | $ (76,690) | $ 1,089,837 |
| Salaries, wages and benefits | 227,641 | 273,242 | 100,512 | 25,780 | | 627,175 |
| Supplies | 57,934 | 27,128 | 687 | 137 | | 85,886 |
| Rent | 37,415 | 49,392 | 1,475 | 37 | | 88,319 |
| Other operating expenses | 126,454 | 168,702 | 4,310 | 11,428 | (76,690) | 234,204 |
| Other income | | | | (3,084) | | (3,084) |
| Depreciation and amortization | 13,014 | 12,113 | 585 | 5,409 | | 31,121 |
| Interest expense | 2 | 31 | | 1,274 | | 1,307 |
| Investment income | (1) | (18) | (1) | (857) | | (877) |
| | 462,459 | 530,590 | 107,568 | 40,124 | (76,690) | 1,064,051 |
| Income from continuing operations before income taxes | $ 44,603 | $ 8,731 | $ 12,576 | $ (40,124) | $ | 25,786 |
| Provision for income taxes | | | | | | 10,631 |
| Income from continuing operations | | | | | | $ 15,155 |

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

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

**(Unaudited)**

**(In thousands)**

| | First Quarter 2009 | | | | | |
|---|---|---|---|---|---|---|
| | Hospital division | Nursing center division | Rehabilitation division | Corporate | Eliminations | Consolidated |
| Revenues | $ 492,509 | $ 529,942 | $ 117,647 | $ | $ (70,624) | $ 1,069,474 |
| Salaries, wages and benefits | 218,245 | 272,482 | 98,196 | 26,295 | | 615,218 |
| Supplies | 54,145 | 25,552 | 487 | 152 | | 80,336 |
| Rent | 36,445 | 47,274 | 1,451 | 31 | | 85,201 |
| Other operating expenses | 119,220 | 156,334 | 3,511 | 11,964 | (70,624) | 220,405 |
| Other income | | | | (2,872) | | (2,872) |
| Depreciation and amortization | 12,512 | 11,685 | 547 | 5,746 | | 30,490 |
| Interest expense | | 40 | | 2,438 | | 2,478 |
| Investment income | (7) | (58) | (2) | (1,408) | | (1,475) |
| | 440,560 | 513,309 | 104,190 | 42,346 | (70,624) | 1,029,781 |
| Income from continuing operations before income taxes | $ 51,949 | $ 16,633 | $ 13,457 | $ (42,346) | $ | 39,693 |
| Provision for income taxes | | | | | | 16,352 |
| Income from continuing operations | | | | | | $ 23,341 |

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

**Operating Data**

**(Unaudited)**

| | 2009 Quarters | | | | | First Quarter 2010 |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | Year | |
| **Hospital data:** | | | | | | |
| End of period data: | | | | | | |
| Number of hospitals | 82 | 82 | 82 | 83 | | 83 |
| Number of licensed beds | 6,520 | 6,520 | 6,520 | 6,580 | | 6,580 |
| Revenue mix %: | | | | | | |
| Medicare | 56 | 55 | 55 | 56 | 55 | 56 |
| Medicaid | 10 | 10 | 11 | 9 | 10 | 9 |
| Medicare Advantage | 10 | 11 | 9 | 9 | 10 | 10 |
| Commercial insurance and other | 24 | 24 | 25 | 26 | 25 | 25 |
| Admissions: | | | | | | |
| Medicare | 7,421 | 7,117 | 6,875 | 7,283 | 28,696 | 7,432 |
| Medicaid | 1,052 | 1,053 | 1,165 | 984 | 4,254 | 997 |
| Medicare Advantage | 1,094 | 1,091 | 926 | 919 | 4,030 | 1,129 |
| Commercial insurance and other | 1,921 | 1,869 | 1,969 | 2,280 | 8,039 | 2,262 |
| | 11,488 | 11,130 | 10,935 | 11,466 | 45,019 | 11,820 |
| Admissions mix %: | | | | | | |
| Medicare | 65 | 64 | 63 | 63 | 64 | 63 |
| Medicaid | 9 | 9 | 11 | 9 | 9 | 8 |
| Medicare Advantage | 9 | 10 | 8 | 8 | 9 | 10 |
| Commercial insurance and other | 17 | 17 | 18 | 20 | 18 | 19 |
| Patient days: | | | | | | |
| Medicare | 197,377 | 197,203 | 188,712 | 196,067 | 779,359 | 202,882 |
| Medicaid | 50,868 | 50,485 | 53,585 | 47,352 | 202,290 | 47,813 |
| Medicare Advantage | 35,229 | 36,806 | 29,912 | 30,315 | 132,262 | 34,524 |
| Commercial insurance and other | 65,509 | 61,960 | 65,717 | 74,253 | 267,439 | 75,483 |
| | 348,983 | 346,454 | 337,926 | 347,987 | 1,381,350 | 360,702 |
| Average length of stay: | | | | | | |
| Medicare | 26.6 | 27.7 | 27.4 | 26.9 | 27.2 | 27.3 |
| Medicaid | 48.4 | 47.9 | 46.0 | 48.1 | 47.6 | 48.0 |
| Medicare Advantage | 32.2 | 33.7 | 32.3 | 33.0 | 32.8 | 30.6 |
| Commercial insurance and other | 34.1 | 33.2 | 33.4 | 32.6 | 33.3 | 33.4 |
| Weighted average | 30.4 | 31.1 | 30.9 | 30.3 | 30.7 | 30.5 |
| Revenues per admission: | | | | | | |
| Medicare | $ 37,262 | $ 37,748 | $ 37,105 | $ 37,620 | $ 37,436 | $ 38,078 |
| Medicaid | 45,160 | 45,759 | 43,640 | 43,314 | 44,465 | 45,738 |
| Medicare Advantage | 46,387 | 46,950 | 47,597 | 47,807 | 47,141 | 45,187 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Commercial insurance and other | 61,286 | 63,716 | 59,957 | 54,662 | 59,647 | 56,344 |
| Weighted average | 42,872 | 43,769 | 42,805 | 42,314 | 42,935 | 42,899 |
| Revenues per patient day: | | | | | | |
| Medicare | $ 1,401 | $ 1,362 | $ 1,352 | $ 1,397 | $ 1,378 | $ 1,395 |
| Medicaid | 934 | 954 | 949 | 900 | 935 | 954 |
| Medicare Advantage | 1,440 | 1,392 | 1,473 | 1,449 | 1,436 | 1,478 |
| Commercial insurance and other | 1,797 | 1,922 | 1,796 | 1,678 | 1,793 | 1,688 |
| Weighted average | 1,411 | 1,406 | 1,385 | 1,394 | 1,399 | 1,406 |
| Medicare case mix index (discharged patients only) | 1.22 | 1.23 | 1.19 | 1.18 | 1.21 | 1.21 |
| Average daily census | 3,878 | 3,807 | 3,673 | 3,782 | 3,785 | 4,008 |
| Occupancy % | 66.0 | 64.7 | 63.6 | 64.3 | 64.7 | 68.2 |
| Annualized employee turnover % | 21.3 | 22.1 | 22.8 | 22.1 | | 21.8 |

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

**Operating Data (Continued)**

**(Unaudited)**

| | 2009 Quarters | | | | | First Quarter |
|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | Year | 2010 |
| **Nursing center data:** | | | | | | |
| End of period data: | | | | | | |
| Number of nursing centers: | | | | | | |
| Owned or leased | 218 | 218 | 218 | 218 | | 218 |
| Managed | 4 | 4 | 4 | 4 | | 4 |
| | 222 | 222 | 222 | 222 | | 222 |
| Number of licensed beds: | | | | | | |
| Owned or leased | 27,138 | 27,138 | 27,086 | 27,038 | | 27,038 |
| Managed | 485 | 485 | 485 | 485 | | 485 |
| | 27,623 | 27,623 | 27,571 | 27,523 | | 27,523 |
| Revenue mix %: | | | | | | |
| Medicare | 35 | 35 | 34 | 33 | 34 | 35 |
| Medicaid | 41 | 41 | 42 | 43 | 42 | 41 |
| Medicare Advantage | 6 | 6 | 6 | 6 | 6 | 6 |
| Private and other | 18 | 18 | 18 | 18 | 18 | 18 |
| Patient days (excludes managed facilities): | | | | | | |
| Medicare | 374,853 | 375,140 | 360,009 | 353,443 | 1,463,445 | 369,102 |
| Medicaid | 1,326,654 | 1,323,157 | 1,357,596 | 1,368,198 | 5,375,605 | 1,312,517 |
| Medicare Advantage | 80,352 | 82,652 | 84,322 | 86,449 | 333,775 | 87,692 |
| Private and other | 403,320 | 415,510 | 415,467 | 403,166 | 1,637,463 | 397,550 |
| | 2,185,179 | 2,196,459 | 2,217,394 | 2,211,256 | 8,810,288 | 2,166,861 |
| Patient day mix %: | | | | | | |
| Medicare | 17 | 17 | 16 | 16 | 17 | 17 |
| Medicaid | 61 | 60 | 61 | 62 | 61 | 61 |
| Medicare Advantage | 4 | 4 | 4 | 4 | 4 | 4 |
| Private and other | 18 | 19 | 19 | 18 | 18 | 18 |
| Revenues per patient day: | | | | | | |
| Medicare Part A | $ 457 | $ 459 | $ 464 | $ 466 | $ 461 | $ 470 |
| Total Medicare (including Part B) | 497 | 500 | 508 | 510 | 503 | 513 |
| Medicaid | 165 | 167 | 166 | 170 | 167 | 168 |
| Medicare Advantage | 380 | 392 | 398 | 405 | 394 | 398 |
| Private and other | 235 | 232 | 234 | 239 | 235 | 238 |
| Weighted average | 243 | 245 | 243 | 246 | 244 | 249 |
| Average daily census | 24,280 | 24,137 | 24,102 | 24,035 | 24,138 | 24,076 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Admissions (excludes managed facilities) | 18,166 | 18,456 | 17,803 | 18,376 | 72,801 | 19,026 |
| Occupancy % | 89.3 | 88.9 | 88.9 | 88.9 | 89.0 | 89.0 |
| Medicare average length of stay | 34.8 | 35.5 | 36.3 | 35.1 | 35.4 | 33.7 |
| Annualized employee turnover % | 37.9 | 39.9 | 40.2 | 38.9 | | 36.7 |
| **Rehabilitation data:** | | | | | | |
| Revenue mix %: | | | | | | |
| Company-operated | 61 | 60 | 59 | 64 | 61 | 64 |
| Non-affiliated | 39 | 40 | 41 | 36 | 39 | 36 |
| Sites of service (at end of period) | 661 | 659 | 660 | 622 | | 619 |
| Revenue per site | $ 177,984 | $ 182,775 | $ 185,797 | $ 183,789 | $ 730,345 | $ 194,094 |
| Therapist productivity % | 84.8 | 84.8 | 83.5 | 83.8 | 84.2 | 83.8 |
| Annualized employee turnover % | 10.9 | 11.6 | 13.1 | 12.8 | | 12.6 |

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## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

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

**Interest Rate Sensitivity**

**Principal Amount by Expected Maturity**

**Average Interest Rate**

**(Dollars in thousands)**

| | Expected maturities | | | | | | | Fair value |
|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 | 2014 | Thereafter | Total | 3/31/10 |
| **Liabilities:** | | | | | | | | |
| Long-term debt, including amounts due within one year: | | | | | | | | |
| Fixed rate | $ 65 | $ 91 | $ 96 | $ 102 | $ 109 | $ 249 | $ 712 | $ 694(a) |
| Average interest rate | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | | |
| Variable rate (b) | $ | $ | $ 196,000 | $ | $ | $ | $ 196,000 | $ 196,000 |

(a) Calculated based upon the net present value of future principal and interest payments using a discount rate of 6%.

(b) Interest on borrowings under the Company s revolving credit facility is payable, at the Company s option, at (1) LIBOR plus an applicable margin ranging from 1.25% to 2.00% or (2) the applicable margin ranging from 0.25% to 1.00% plus the higher of the prime rate or 0.5% over the federal funds rate. The applicable margin is based upon the Company s average daily excess availability as defined in the Company s revolving credit facility.

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## ITEM 4. CONTROLS AND PROCEDURES

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

The Company has carried out an evaluation under the supervision and with the participation of management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of March 31, 2010, the Company s disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that the Company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

There has been no change in the Company s internal control over financial reporting during the Company s quarter ended March 31, 2010, that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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

### Item 6. Exhibits

| | |
|---|---|
| 10.1 | Termination of Lease and Notice of Lease dated as of January 22, 2010 by and among HCRI Massachusetts Properties Trust, HCRI Massachusetts Properties Trust II and Kindred Hospitals East, L.L.C. |
| 10.2 | Termination of Lease and Notice of Lease dated as of January 22, 2010 by and among HCRI Massachusetts Properties Trust, HCRI Massachusetts Properties Trust II, Kindred Hospitals East, L.L.C. and KND Real Estate 26, L.L.C. |
| 10.3 | Employment Agreement dated as of March 30, 2010 by and between Kindred Healthcare Operating, Inc. and Benjamin A. Breier. Exhibit 10.1 to the Company s Current Report on Form 8-K dated March 30, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference. |
| 31 | Rule 13a-14(a)/15d-14(a) Certifications. |
| 32 | Section 1350 Certifications. |

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## SIGNATURES

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

**KINDRED HEALTHCARE, INC.**

Date: May 7, 2010

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

Date: May 7, 2010

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