

**THE FINANCIAL COLLAPSE OF HEALTHSOUTH**  
**Part 2**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
OVERSIGHT AND INVESTIGATIONS  
OF THE  
COMMITTEE ON ENERGY AND  
COMMERCE  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED EIGHTH CONGRESS  
FIRST SESSION

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## THE FINANCIAL COLLAPSE OF HEALTHSOUTH

WEDNESDAY, NOVEMBER 5, 2003

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON ENERGY AND COMMERCE,  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. James C. Greenwood (chairman) presiding.

Members present: Representatives Greenwood, Stearns, Burr, Walden, Ferguson, Rogers, DeGette, and Davis.

Staff present: Kelli Andrews, majority counsel; Ann Washington, majority counsel; Casey Hemard, majority counsel; Mark Paoletta, majority counsel; Tom DiLenge, majority counsel; Yong Choe, legislative clerk; Jill Latham, legislative clerk; Auturo Silva, deputy communications director; Edith Holleman, minority counsel; and Voncille Hines, minority research assistant.

Mr. GREENWOOD. This hearing of the Oversight and Investigations Subcommittee of the House Committee on Energy and Commerce will come to order.

And the Chair recognizes himself for the purpose of making an opening statement.

This morning we hold the second day of our hearing on the financial collapse of HealthSouth. Yesterday HealthSouth's former CEO and Chairman of the Board Richard Scrushy was indicted by a Federal Grand Jury on 85 counts of criminal conduct, including allegations of money laundering, securities fraud and of being the ringleader of a vast conspiracy to defraud HealthSouth's investors.

Mr. Scrushy stands accused of masterminding a scheme to boost the company's income over a period of 7 years by \$2.7 billion. \$2.7 billion; that is an incredible amount of money. How many retirees invested their savings with HealthSouth relying on figures that told them the Company was in sound financial health? How many young families just starting out decided to invest their hard earned dollars in HealthSouth relying on the public statements of CEO Richard Scrushy?

In my view, the overarching themes of Mr. Scrushy indictment are greed and more greed with a good dose of intimidation.

According to the indictment, over a period of 7 years Mr. Scrushy received about \$267 million in compensation from HealthSouth, including \$53 million in bonuses alone. These amounts are truly staggering. Keep in mind, this does not include any proceeds that Mr. Scrushy may have received from investments made from

HealthSouth related companies. It does not include other business ventures that Mr. Scrushy participated in with various HealthSouth Board members.

Mr. Scrushy's \$267 million, 7 year compensation package also does not include HealthSouth's financing of Mr. Scrushy's entertainment vehicle that included the girl band Third Phase, nor the 13 private jets that HealthSouth purchased under his watch.

As we now know, Mr. Scrushy received with the blessings of the Board's compensation committee a \$10 million bonus in 2002. This is the same year that HealthSouth's stock lost half its value in a couple of days following the company's August 27 announcement. So while Mr. Scrushy raked in tens of millions, HealthSouth's shareholders watched their investment disintegrate.

Today we will have the opportunity to question members of the Board of Directors about Mr. Scrushy's outrageous compensation.

The criminal indictment of Mr. Scrushy also validates many of the concerns raised by various witnesses in our hearings a few weeks ago, including the intimidating atmosphere fostered by Mr. Scrushy that included hidden cameras and armed security guards. This indictment alleges that in connection with the conspiracy to inflate HealthSouth earnings, Mr. Scrushy controlled "his co-conspirators, HealthSouth employees and the Board of Directors by threats, intimidation, taking various steps to monitor the activities of such persons, including obtaining and reading their emails, placing them under surveillance and installing equipment that permitted him to eavesdrop on electronic and telephonic communications, obtaining large compensation package for coconspirators and recommending the forgiveness of HealthSouth loans to coconspirator" from the indictment.

Today we will have the opportunity to hear from various Board members about their experiences with Mr. Scrushy and the ways in which he exerted control over them collectively and individually.

Three weeks ago this subcommittee looked at internal safeguards at the company failed allowing this fraud to take place. Today we will look at the role other parties played in this debacle, including the Board of Director, the external auditors, the investment bankers and other advisors.

In the course of examining how management of a Fortune 500 company could commit a \$2.7 billion fraud, we have reviewed the oversight exercised by the Board of Directors over the years. And what we have learned raises serious concerns. Among the concerns is a lack of formal procedures. This was best illustrated in our hearing 3 weeks ago when former corporate counsel Bill Horton confirmed that although there were multiple audit committee meetings in 2001, minutes were only maintained at one of those meetings.

Our examination has also revealed that Board members had business relationships with HealthSouth and Mr. Scrushy raising questions about how they dealt with conflict of interest. These are just a few of the areas I look forward to discussing with Board members this morning.

As we probe how the massive fraud could go undetected for so long, we will hear from HealthSouth's external auditor, Ernst & Young. In addition to performing HealthSouth's financial audits,

Ernst & Young also performed operational examinations known as pristine audits, for which they were paid even greater fees than for the financial audits.

I look forward to hearing from Ernst & Young about how it could maintain its independence in performing financial audits when it was also engaged in another higher revenue area of work with HealthSouth.

During our last hearing we heard from former HealthSouth employee Michael Vines who contacted Ernst & Young with allegations of fraud. This morning the former engagement partner and senior manager on the account can describe for us in detail how they responded to the allegations.

We are also joined by HealthSouth's lead investment bankers for over 15 years. We are interested in learning from them whether their due diligence process for large debt offerings they were leading on behalf of HealthSouth they ever raised any questions about HealthSouth's financial condition. And if not, why not?

We are also interested in understanding how investment bankers with expertise in healthcare companies and a longstanding relationship with HealthSouth did not question HealthSouth's assertion that a Medicare billing directive would have an immediate impact of a significant portion of the company's revenues.

Finally, we will explore the issues associated with a company conducting its own internal investigation into matters relating to conduct of its executive officers. For example, we will explore the issue of independence surrounding these internal investigations sanctioned by a corporation's Board of Directors and whether HealthSouth's internal investigation was in any way compromised at all.

We look forward to asking two of the attorneys that worked on HealthSouth's internal investigation questions on these matters.

I want to thank all of the witnesses for attending.

I now recognize the gentlelady from Colorado, Ms. DeGette, for her opening statement.

Ms. DEGETTE. Thank you, Mr. Chairman, for holding this second hearing on the multibillion dollar HealthSouth financial fraud. But more importantly, thank you for this very illuminating series of hearings we have had over the last few years on corporate responsibility issues.

Three weeks ago this very subcommittee watched as the smug former CEO of HealthSouth, Richard Scrushy, proclaimed his innocence in an interview with "60 Minutes." In that interview Mr. Scrushy maintained that dispute the allegations of fraud and the 15 executives of HealthSouth that had already plead guilty to fraud, he did not anticipate criminal charges. "I did not expect that at all," he said. "I think an objective review of the evidence will show that Richard Scrushy was not involved in any of these alleged crimes, and they will see that I was not part of the scheme."

Indeed, an objective review of the evidence is in, and as we just heard yesterday Mr. Scrushy was indicted with 85 counts of fraud ranging from conspiracy to mail, wire and securities fraud and money laundering. A veritable smorgasbord of charges.

The basic allegation is that Mr. Scrushy directed a broad conspiracy of at least 15 other HealthSouth officers to inflate

HealthSouth's revenues quarter after quarter, year after year. Allegedly, over a 7 year period Mr. Scrushy and his team inflated revenues by \$2.7 billion, cash by \$370 million, goodwill by \$740 million and put a billion dollars of fictitious assets on its balance sheet.

While the degree of alleged fraud at HealthSouth is breathtaking, it is no means unique. We have seen this sort of trickery, deceit and greed at Enron, Qwest, World Com and many others. In each of these cases management's self-interest has triumphed over its obligations to shareholders. And, of course, the result is that investors have lost billions.

But as we take a step back and examine egregious instances of fraud, another disturbing pattern emerges, a pattern in which the Board of Directors, the very entity that has the fiduciary duty to protect the shareholders of a company, merely pandered to the whims of management in order to satisfy their own selfish interests. These Boards, awash in conflicts, functioned as a rubberstamp approving highly risky transactions without question and never examining the dubious write-offs and one time charges that were routine in the financial statements. They consistently acted in their self-interest, not asking the difficult questions nor conducting the proper due diligence for fear that their takings may be in jeopardy. However, these are not just instances of negligence and complacency. In the end these Boards functioned as the enablers of corporate fraud.

In the case of HealthSouth, several of the Board members who are here today have served on HealthSouth's Board for nearly 20 years, presiding over, knowingly or otherwise the fraudulent actions of Mr. Scrushy and yet not one of them raised a red flag. There are some obvious reasons for this.

The HealthSouth Board was riddled with conflicts of interests. The directors invested in Mr. Scrushy's business ventures and he invested in theirs. They allowed HealthSouth to sign contracts with companies in which they had financial interested without even a cursory review of the fairness of those contracts.

For example, they did not ask questions about why HealthSouth was investing in and giving its business to Source Medical, in which dozens of company officials had investments. The audit company rarely met and seemed unconcerned that the internal audit function was weak, underfunded and had no access to the corporate books. The compliance committee, apparently, never knew that there were no procedures in place for independent investigation of potential criminal activities at the highest levels of the company. They never heard about employees' allegations of significant changes at the end of every quarter.

Directors raised questions about the restructuring and the one time write-off charges that appeared every year, but then they never went any further to discuss them with the auditors.

The Board acquiesced in September 2002 when Mr. Scrushy decided that the independent law firm hired by HealthSouth to investigate the allegations against Mr. Scrushy would also become the company's SEC defense attorney and, of course consequently under Mr. Scrushy's control. It acquiesced when Mr. Scrushy fired FTI Consulting, the company that was supposed to be reviewing the im-

pact of Transmittal 1753 before getting a final report. The result was that they never heard that the author had serious questions about the truth of the statements made by Mr. Scrushy in the 2002 third quarter investor call about the impact of Transmittal 1753.

But as in the case of Enron and others, such fraudulent activity extends well beyond the management team and the Board of Directors. It reaches the auditors who were signing off on statements quarter after quarter. It extends to the bankers who, suspicious of the company's finances, unconditionally provided capital as well as a buy rating on the company's stock. And Ernst & Young never noticed that \$370 million in cash on the HealthSouth books didn't exist, nor \$740 million in goodwill, or a billion dollars in fixed assets. They did not notice the dozens of nonstandard journal entries made by the corporate accounting department to change the contractual adjustment entries submitted by the facilities. And I could go on and on.

Yesterday's indictment of Mr. Scrushy, the first indictment of a CEO under Sarbanes-Oxley, is an example of the effectiveness of the legislation crafted by this committee designed to curtail corporate malfeasance. However, Mr. Chairman, such legislation is just a first step on the long road to adequate corporate reform. We must ensure that there are appropriate policies in place so to guarantee that directors are truly independent and act in the interest of the shareholders.

To date, Congress has addressed the responsibility of corporate officers and auditors, and that is a good first step. But we have not addressed the responsibility of the board to assure shareholders that fraud is not being committed. It is time that we do so.

Thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentlelady and recognizes for an opening statement the vice chairman of the subcommittee, the gentleman from Oregon, Mr. Walden.

Mr. WALDEN. Thank you very much, Mr. Chairman. And thank you for convening this second hearing on the financial collapse of HealthSouth.

The subcommittee's previous hearing shed some light on the internal workings of this healthcare giant. After the first hearing I was left with the feeling that many opportunities to report, address and halt the coordinated fraud that was occurring at HealthSouth were either missed or ignored. One lie led to another and each dishonest inflated profit statement stood on the shoulders of the previous one.

Much of the fraud that was committed by former HealthSouth executives preceded the landmark Sarbanes-Oxley Corporate Accountability Act. Now, as a result of that act CEOs and CFOs are now required to certify to the truthfulness of their company's financial reports. External auditors must attest to a company's internal controls. Audit committee members are required to be independent of corporate management. Whistleblower procedures must be established and complaints to be made to the independent audit committee, not management. And it's now a Federal offense for corporate officers to mislead outside auditors.

The timing of this fraud relevant to the implementation of Sarbanes-Oxley does not make it more palatable nor less lawful. How-

ever, now that Congress has taken decisive steps to tighten internal controls, enhance corporate governance and encourage employees from executives to rank and file to report fraud, I am hopeful the tide will turn and instances of unchecked corporate fraud will become a thing of the past.

But at the end of the day Congress cannot legislate the morality or integrity of CEOs and CFOs of our Nation's publicly traded companies. However, we have an obligation to investors to make the framework is in place to catch fraudulent and criminal acts, force refunds of ill-gotten gains and exact appropriate punishment on those who commit such acts.

We also have a responsibility to monitor current laws and regulations and to investigate where gaps may exist, and fill them.

With that said, I am eager to hear from our witnesses on the usefulness of Sarbanes-Oxley in routing out fraud, on how we regain investor confidence and present subsequent devastating financial failures.

I am also interested in hearing from the Board of Directors who are represented today on what they saw and what they did not see, and how other boards of other major corporations might spot what you missed.

Mr. Chairman, I look forward to the opportunity to hear from our panel.

And I return the balance of my mine.

Mr. GREENWOOD. The Chair thanks the gentleman.

The gentleman from Michigan, Mr. Rogers, for an opening statement.

Mr. ROGERS. I will waive my statement this morning, Mr. Chairman.

Mr. GREENWOOD. Mr. Ferguson from New Jersey.

Mr. FERGUSON. Thank you, Mr. Chairman.

Thanks for holding this important hearing, this subcommittee's second, on the egregious fraud carried out by the management at HealthSouth. I want to commend you, Mr. Chairman, and the committee staff for all the hard work that has gone into holding these hearings and to investigate the fraud that took place at this huge company.

Yesterday, as was noted, former HealthSouth CEO Richard Scrushy received a special delivery from the United States Department of Justice. Unfortunately for Mr. Scrushy, this delivery was not another Rolls Royce or another Renoir or Picasso to add to his collection. Instead, he was delivered a 38 page indictment detailing 85 criminal counts for his suspected role as the ringleader in the massive fraud propagated by the executive team at HealthSouth. This fraud has led to no fewer than 15 former HealthSouth employees, including 6 former chief financial officers and other key executives to plead guilty to crimes related to this fraud. Each has implicated Mr. Scrushy as the fraud's mastermind.

The number of HealthSouth employees who have pled guilty in this scheme number more than those who have been indicted in the Enron, Tyco, WorldCom and Global Crossing cases combined.

Mr. Scrushy represents the first indictment of a corporate executive under the newly enacted Sarbanes-Oxley Act. In fact, the strict

standards of accountability set up by Sarbanes-Oxley may have been what led this massive collusive fraud to have been revealed.

In our last hearing we heard from a panel of people who noticed bad things happening at HealthSouth. They said they wanted to do the right thing, but in each case they failed to reveal the fraud to any outside the company. They dealt with it internally and each time their concerns were stifled by management complicit in the fraud.

One component of Sarbanes-Oxley was that an independent whistleblower channel to the audit committee was established for all public companies. Perhaps this would have motivated whistleblowing employees to break away from internal management and finally go to the audit committee, or even alert the outside auditors.

Most importantly, however, I am pleased to see that this law will hold accountable a man who, according to the indictment, led a large group of conspirators to cook the books for their own personal gain. Tragically, their gain came at the expense of thousands of innocent shareholders and employees who invested their savings, their careers, their whole livelihood in HealthSouth. Unfortunately, the team of bad actors at HealthSouth was bent on conspiring to defraud the investing public, their auditors and even the Federal Government with no regard for their fiduciary responsibilities to innocent stakeholders and the public.

The company has now purged many of the bad actors. There are still well meaning Board members and others, people who care about this company and their employees and their investors, and we will hear today about they are doing to right the ship and to reform the ills that have plagued the company prior to this year.

I look forward to hearing from the witnesses today and for learning more about how to prevent these types of tragedies in the future.

I thank you, Mr. Chairman.

I yield back.

Mr. GREENWOOD. The Chair thanks the gentleman.

The gentleman from Florida, Mr. Stearns, for an opening statement.

Mr. STEARNS. Good morning, and thank you, Mr. Chairman.

I also, like my colleagues, commend you for holding this second hearing on the financial scandal at HealthSouth.

This is an important hearing. It comes at a time when many things are converging on Wall Street and here in Washington.

We heard last month from employees inside. Today we broaden our scope to hear from the accounting firm as well as the Board of Directors.

I think the question most of us are asking with the indictment of Mr. Scrushy, you have 15 other executives, senior executives, 5 CFOs that go back intermittently I think almost to 1986, and then you have 10 other senior level people, treasurer, comptroller all cooperating, also admitting there was fraud. So in this sea of fraud with 15 senior level executives admitting and cooperating, is it possible that the Board of Directors and the accounting firm knew nothing about this? And I guess the question they would have to ask themselves, since the Board of Director's primary responsibility

is to the shareholders, did they exercise their fiduciary responsible and duty for them.

I read this interview, a portion of the interview in the corporate Board minutes. And I say this to my colleagues, we have this article "My Sixteen Days on the HealthSouth Board." And this is by Betsy Atkins.

She went on the Board on March 7, 2003. And, of course, by then came March 19, 11 days later when everything fell apart when the FBI agents started to break down the door.

One of the first things she noticed and she says in the article, is the "dozen or so law firms that the company was paying." "Nationally and locally, and some of them were billing like crazy." And so was this a telltale sign?

And I think, Mr. Chairman, it might be careful for our counsel, our counsel to talk to her at some later time.

I think that, as someone else mentioned about the Sarbanes-Oxley Act, I think it was in effect helping and working. So I think that's a good point. There is some good news out of this hearing.

As Chairman of the Commerce Consumer Protection Trade I have jurisdiction over FASB, which the Financial Accounting Standards Board. So I am interested to see if all of that has a role here, the accounting standards and so forth. But it does not appear to be as much as so as it was in Enron.

So, Mr. Chairman, I again commend you and this staff for doing a good job in having this hearing. And I look forward to the testimony.

Mr. GREENWOOD. The Chair thanks the gentleman.

If there are no other members prepared to make opening statements, we'll call forth our first panel, which consists of one individual, Mr. Gregory Wallance. Mr. Wallance, good morning, sir.

Mr. Wallance is a member of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines of the U.S. Sentencing Commission.

Good morning, sir. Thank you for joining us.

Is your microphone turned on? Push the button there.

Before you begin, I need to advise you that this is an investigational hearing and we take our testimony under oath, and I need to ask you if you have any objections to giving your testimony under oath.

Mr. WALLANCE. I do not.

Mr. GREENWOOD. Okay. You have the right to be represented by counsel before this subcommittee. Do you wish to be represented by counsel?

Mr. WALLANCE. No, no. I waive that right. Thank you.

Mr. GREENWOOD. You are not on the hot seat, sir. But I do need you to stand your right hand.

[Witness sworn.]

Mr. GREENWOOD. Okay. Thank you, sir. You are now under oath and now we would be delighted to hear your opening statement, sir.

**TESTIMONY OF GREGORY J. WALLANCE, MEMBER, AD HOC ADVISORY GROUP, ORGANIZATIONAL SENTENCING GUIDELINES, U.S. SENTENCING COMMISSION**

Mr. WALLANCE. Great. Well, thank you, Chairman Greenwood, thank you members for the opportunity to be here this morning.

My name is Gregory J. Wallace. I am currently a partner at Kaye Scholer, a law firm in New York City. I served for 5 years as a Federal prosecutor. My current practices involves representation of both corporations and individuals in white collar cases, as well as advising companies on corporate compliance and internal investigations. And these are subjects on which I write and lecture.

Recently I had the privilege of serving as a member of the Ad Hoc Advisory Group to the United States Sentencing Commission on the Organizational Sentencing Guidelines. Our recent report, issued on October 7, addressed among other issues the role and responsibility of the board of directors or highest governing authority of an organization to assure that the organization's business activities fully comply with the law. And I think it is worth noting that the Sentencing Commission gets a great deal of credit for, in effect, revolutionizing the field of corporate compliance.

In 1991 the Commission promulgated the Organizational Sentencing Guidelines to govern the sentencing of organizations for most offense in Federal court. A critical feature of those guidelines was an embedded carrot and stick. If a corporation implemented an effective compliance program, then if it ended up facing a criminal conviction, it would receive a significantly more lenient fine if it had such a program. But, if it failed to implement such a program, then it would receive a significantly higher fine, and in some cases dramatically so.

And the Organizational Sentencing Guidelines describe seven steps that a corporation could take to assure itself that it had such an effective program, including certain auditing and monitoring procedures, disciplinary measures and the like. However, the guidelines were silent on the role of a board of directors in ensuring compliance with law on the part of the corporation.

On the tenth anniversary of those guidelines, the Sentencing Commission announced the formation of our Advisory Group. We were empaneled in February 2002. There were 15 of us, a variety of experiences, academics, former prosecutors, former high level Department of Justice official, and a sitting United States Attorney. We were tasked with reviewing the effectiveness of the Organizational Sentencing Guidelines with special emphasis on these particular criteria for a compliance program.

Two factors were very influential in our report. First, was simply the passage of time. In the 10 years since the enactment of these guidelines, there had been a great deal of experience in the design and implementation of compliance programs. But the second was that the formation of our committee, our advisory group, coincided with the corporate scandals involving Enron, WorldCom, Tyco and Adelphia, which greatly contributed to the public's lack of confidence in the capital markets and which also led to very significant legislative and regulatory changes effecting corporate governance.

What struck was that in all of these, or most of these scandals, the alleged malfeasance occurred at the senior management level and occasionally at the board level. Even when there was no actual malfeasance by members of the board, there were often instances of negligence. As a result, we concluded that the current absence in the organizational guidelines criteria for an effect program of any mention of the board of directors' role needed to be addressed. In effect, the obvious needed to be stated. Ultimately the board of directors is responsible for all of the activities of the organization including its compliance with law.

And while I'll save for questions the details of some of our recommendations, I want to give you the essence of what we suggested needed to be incorporated in any amendments of these guidelines, and it's that as follows:

That the board can only perform this oversight function if it reasonably educated about the business of the organization and the illegal activities to which it might be exposed to the foolish and misguided deeds of its employees and, if the board is actively, indeed proactively engaged in compliance oversight.

And, again, I am happy to give you more details in response to questions.

In making these recommendations, though—and pardon me, I am a little bit horse. We do not think that we were breaking new ground.

Mr. GREENWOOD. You are welcome to help yourself to a glass of water there.

Mr. WALLANCE. Thank you.

Over the years I think you could find that essentially the same standards laid out in a variety of pronouncements by both courts, commentators and professional organizations. But, unfortunately, over the past 2 years we have learned the bitter lesson that lessons can never be learned enough. And we therefore hope that this report will be of assistance both to the Sentencing Commission as it considers possible amendments to the guidelines, as well as to this committee in the course of its investigation.

So thank you, and I'd be pleased to answer any questions.

[The prepared statement of Gregory J. Wallance follows:]

PREPARED STATEMENT OF GREGORY J. WALLANCE

Thank you Chairman Greenwood, Members.

My name is Gregory J. Wallance. I am currently a partner at Kaye Scholer LLP, a New York based law firm. I served for five years as an Assistant United States Attorney in the Eastern District of New York. My practice currently involves white collar defense representation of both individuals and corporations, internal investigations and advising corporations on corporate compliance. I also lecture and write on corporate governance and compliance. I am grateful for the opportunity to appear before this Committee to address the issue of the role and responsibility of a board of directors of a corporation in assuring that the corporation's activities fully comply with the law.

Recently, I had the privilege of serving as a member of the Ad Hoc Advisory Group to the United States Sentencing Commission on the Organizational Sentencing Guidelines, whose recent report addresses this issue. As background, the Sentencing Commission deserves a great deal of credit for, in effect, revolutionizing the field of corporate compliance. In 1991, the Commission promulgated the organizational sentencing guidelines ("OSG"), also known as the Chapter 8 guidelines, to govern the sentencing of organizations for most federal criminal violations. The OSG became effective on November 1, 1991. They provide incentives for organizations to report violations of law, cooperate in criminal investigations, discipline responsible

employees and take the steps needed to prevent and detect criminal conduct by their agents. A critical feature of the OSG was the creation of a sentencing credit for organizations that put in place “effective programs to prevent and detect violations of law.” For organizations that have no such program, the OSG mandate high fines, in some instances, dramatically so. The OSG described 7 steps that an organization could take to implement such a program, including the use of auditing and monitoring systems, dissemination of compliance materials, and means for employees to report violations of law without fear of retaliation.

Although such a compliance program is not a legal obligation, corporations began implementing them. One commentator noted that, “without question, the organizational sentencing guidelines “greatest practical effect thus far is to raise the business community’s awareness of the need for effective compliance programs.”<sup>1</sup> The OSG even shaped corporate governance law. In 1995, the Delaware Chancery Court, in *In re Caremark Litigation*, approved settlement of a shareholder derivative suit alleging that the Caremark directors had breached their duty of care by failing to supervise the conduct of Caremark’s employees. In doing so, the court emphasized the importance of the role and responsibility of the board of directors to assure that the corporation functions within the law to achieve its purpose. The Chancery Court stated that the OSG “offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered and to take prompt, remedial efforts.” The Court distinguished a prior opinion that arguably could be read to state that directors have no responsibility to assure that adequate reporting systems are in place, by stating: “Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that the federal sentencing guidelines offer.”<sup>2</sup>

On the tenth anniversary of the OSG, the Sentencing Commission announced the formation of the Advisory Group. We were empaneled in February 2002. The Group consisted of 15 lawyers, former prosecutors and Department of Justice officials, academics, compliance professionals and a United States Attorney, all with wide experience in corporate governance and compliance programs. The Advisory Group was tasked with reviewing the general effectiveness of the guidelines for sentencing corporations, with special emphasis on the application of the criteria for an effective compliance program. We were asked to submit a final report to the Commission in 18 months. The Advisory Group sought and reviewed information from a variety of sources, both in written statements and at a public hearing.

Two factors were especially influential in shaping our report. One was simply the passage of time. In the 10 years since the OSG became effective, a great deal of experience had been gained in designing and implementing compliance programs. The other was that the formation of the Advisory Group coincided with the corporate scandals involving Enron, Worldcom and other companies, which greatly contributed to the public’s lack of confidence in the capital markets. The scandals also led to significant legislative and regulatory changes affecting corporate governance and compliance.

The Advisory Group delivered its report to the Sentencing Commission on October 7, 2003. The report, 138 pages in length with 444 footnotes, contains an appendix setting forth the recommended OSG compliance criteria. The report is notable for several important proposals.

First, the Advisory Group recommended that the Sentencing Commission promulgate a stand-alone guideline, § 8 B2.1, defining “an effective program to prevent and detect violations of law.” Currently, the criteria for such a program is in the Chapter 8 guidelines’ commentary. The recommendation was intended to give the compliance criteria for an effective program special emphasis and visibility.

Second, in the proposed new guideline, the Advisory Group proposed, inter alia, the following changes to those criteria:

- emphasizing the importance of an organizational culture that encourages an organizational-wide commitment to compliance with the law.
- provision of a definition of “compliance standards and procedures.”
- specification of the responsibilities of an organization’s governing authority and organizational leadership for compliance.
- providing adequate resources and authority to individuals with responsibility for the implementation of the program.

<sup>1</sup>Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 *Was. U.R.Q.* 375 (1993).

<sup>2</sup>*In re Caremark Int'l*, 698 A.2d 959, 970 (Del. Ch. 1996).

- revision of the current terminology “propensity to engage in violation of law,” which has been the source of considerable confusion in the past.
- inclusion of training and dissemination of compliance training materials and information as a criteria for an “effective program.”
- requiring as part of monitoring and auditing the “periodic evaluation” of the effectiveness of the compliance program.
- a mechanism for anonymous reporting.
- on-going risk assessments as part of the implementation of an effective program.

Third, the Ad Hoc Group recommended modifications to the OSG to clarify under what circumstances a waiver of the attorney-client privilege and work product protections is required for an organization to receive credit for cooperation with law enforcement.

Of special interest to this committee are the Advisory Group’s recommendations regarding the role of the “governing body”—in most cases a board of directors—in assuring that the corporation complies with the law. In virtually all of the recent corporate scandals, the alleged malfeasance occurred at the senior management end/or governing authority level. Even where there was no actual malfeasance by members of the governing authority, there were often instances of negligence.<sup>3</sup>

As a result of the foregoing, the Advisory Group concluded that the current absence in the OSG of any discussion of the role of the governing authority needed to be addressed. In effect, the obvious needed to be stated: *ultimately, the governing authority is responsible for the activities of the organization.*<sup>4</sup> It can only perform this function if its members are reasonably educated about the business of the organization and actively engaged in compliance oversight.

The Advisory Group therefore proposed a new guideline defining the compliance roles of the organizational leadership at three levels: (1) members of an organization’s governing authority, which generally means the Board of Directors;<sup>5</sup> (2) executives comprising an organization’s managerial leadership; and (3) one or more individuals having primary, day to day responsibility for the organization’s program to prevent and detect violations of law. To quote from the proposed guideline:

- “The organizational leadership shall be knowledgeable about the content and operation of the program to prevent and detect violations of law.”
- “The organization’s governing authority shall be knowledgeable about the content and operation of the program to prevent violations of law and shall exercise reasonable oversight with respect to the implementation and effectiveness of the program to prevent and detect violations of law.”
- “Specific individual(s) within high-level personnel of the organization shall be assigned direct, overall responsibility to ensure the implementation and effectiveness of the program to prevent and detect violations of law. Such individual(s) shall be given adequate resources and authority to carry out such responsibility and shall report on the implementation and effectiveness of the program to prevent and detect violations of law directly to the governing authority or an appropriate subgroup of the governing authority.”

As to the top level body in charge of organizational affairs, i.e., the Board of Directors, the proposed guideline states that the Board should be knowledgeable about the content and operation of the organization’s compliance program. The Board’s knowledge about program features and operations should include, *inter alia*, practical management information about the major risks of unlawful conduct facing their organization; the primary compliance program features aimed at counteracting those risks; and the types of problems with compliance that the organization and other parties with similar operations have encountered in recent activities.

Significantly, the proposed guidelines do not specify the fact finding procedures or methods that members of a governing authority should use in acquiring this type of information. The proposed guidelines leave to the particular organization the choice of methods to gather and deliver information to governing authority in a manner that best fits the organization’s overall operations.

Under our proposed guideline, the governing authority should exercise reasonable oversight with respect to the implementation and effectiveness of the program. This obligation recognizes that such oversight is a key part of the duties of top level orga-

<sup>3</sup> See the role of the Board of Directors in Enron’s collapse, S. Rep. No. 107-70(2002).

<sup>4</sup> Most commentary received by the Advisory Group supported adding specific references to the guidelines to amplify the role of the governing authority, providing direct access between the governing authority (or one of its committees) and a company’s compliance officer, to ensure prompt and unfiltered communications.

<sup>5</sup> As defined in commentary to this proposed guideline and Application Note 1, the “governing authority” of an organization is “(A) The Board of Directors or (B) if the organization does not have a Board of Directors, the highest level governing body of the organization.”

nizational officials. Effective management requires that a Board of Directors, for example, be *proactive*. They must seek information about compliance programs, evaluate such information when received, and monitor the implementation and effectiveness of responses when compliance problems are detected.

For example, the governing authority of the organization or some appropriate subgroup (such as an audit committee) should receive periodic reports from the person or persons in high level management with direct, overall responsibility for an organization's compliance program. The Advisory Group's report envisions that a board of directors would hear from such persons periodically as to the nature, progress and success of the compliance program without the potential filtering or censoring influence of senior organization managers. In cases of actual or apparent involvement in, or support for, illegal conduct by top level organizational executives, our report suggests that the head of the organization's compliance program should take steps to ensure that the course of this behavior are made directly known to the organization's governing authority, or an appropriate subgroup of the governing authority, or the organization's qualified legal compliance committee.

In addition, as described in the proposed new commentary at § 8B2.1 Application Note 3 (B), the governing authority or an appropriate subgroup, periodically should receive information on the implementation and effectiveness of the compliance program from the individual or individuals with day-to-day operational responsibility for the program. Direct contact with those who have such day-to-day responsibility will, for example, help the governing authority more effectively assess the adequacy of resources being made available to the program.<sup>6</sup>

In making these recommendations, we do not think that we were breaking new ground. More than 7 years ago, the *In re Caremark* decision had defined the role of the board of directors in substantially the same terms.

More recently, the Conference Board's Commission on Public Trust and Private Enterprise stated in a similar manner:

In fulfilling its oversight function, boards must monitor management's operating performance as well as ethical and legal compliance. In approving strategies, boards need to understand, among other things, the corporation's capital allocation, debt levels, risks and vulnerabilities, compensation strategy and growth opportunities. Importantly, they must engage management on the central issues facing the company and have a firm grasp on the tradeoffs that lie at the heart of a corporate enterprise.<sup>7</sup>

Unfortunately, over the past two years we have learned the hard lesson that lessons can never be learned enough. We therefore hope that the Advisory Group's report will be of assistance to the Commission as it considers amendments to the OSG and to this Committee in the course of its investigations.

Thank you.

Mr. GREENWOOD. We thank you very much for your testimony and for your willingness to help us in this endeavor.

The Chair recognizes himself for 10 minutes for our questioning.

Mr. WALLACE, would it be fair to say that the Advisory Group's report was designed, at least in part, to help companies improve their corporate governance by providing them with additional guidance regarding the factors that are likely to result in effective programs to prevent and detect violations of law?

Mr. WALLACE. Yes. Yes. That is correct. And I do not mean to suggest in my remarks that the only issue we were addressing was the role of the board of directors. In fact, we provided, I think, which are a number of recommendations in a variety of areas from auditing and monitoring to disciplinary measures, to—and I think

<sup>6</sup>As stated in the Report at p. 61, "Typically, however, members of a governing authority will gain information on the features and operations of a program to prevent and detect violations of law through reports from senior organization managers or other experts (in large organizations), or through information about program features and operations gained in the course of day-to-day management and oversight of related organizational activities (in small organizations). The proposal anticipates that members of a governing body will update their information about program features and operations periodically. This update would occur at least annually, and more frequently when legal changes or shifts in organizational activities raise new compliance risks for the organization."

<sup>7</sup>The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 2: Corporate Governance (January 9, 2003) p.9.

this is one of our significant recommendations—that the objective of the compliance program has to be to create a culture of compliance such that commitments to compliance with law is as important a value to the business as a profit margin or revenue growth, or what have you.

Mr. GREENWOOD. Okay. At this point I would like you to turn your attention to the report itself. One of the recommendations in the report was to expand the definition of “effective program to present and detect violations of the law to include two essential components: (1) Exercise due diligence, and; (2) Otherwise promote an organizational culture that encourages a commitment to compliance with law.” That’s on pages 52 to 54.

Mr. WALLACE, how important is it for organizations to create a culture in which compliance with the law is the expected behavior rather than an unwelcome constraint?

Mr. WALLANCE. I think it is paramount. Ultimately to be effective, the commitment to compliance has to come from the very top of the organization, otherwise employees are not going to respond. And it is the notion of creating an embedded culture of compliance that we were driving at.

Now, we are not suggesting that there is some elusive goal here that is somewhat touchy-feely, if you will. What we were careful to point out is that you achieve this culture of compliance, not simply by saying it or mouthing the words. It is not enough to talk-the-talk, you have got to walk-the-walk. And if the company implements the specific criteria or recommendations that we sent out, then we think it will achieve the corporate compliance culture which is best designed to deter the kind of breakdowns in corporate governance that we have witnessed over the last 2 years.

Mr. GREENWOOD. Okay. Can you detail some steps that companies should or could take to ensure such a culture of compliance?

Mr. WALLANCE. Well, I think it is a range, and let me identify a couple of areas. I think companies need to do risk assessments. What do our kinds of business, what kind of potential violations of law do our business activities expose us to? What kinds of legal problems have companies in similar business lines encountered in the past? And then once it has made that assessment, direct the resources of its compliance program to deterring and preventing those kinds of violations of law.

We suggested that not only does there need to be effective auditing and monitoring, but in fact the compliance program itself should be periodically audited and monitored for its own effectiveness, which is a standard accounting tool. But it is not enough to set it up. You have got to make certain it is working.

We suggested that training should be a necessary part of any compliance program. Training of all employees at virtually of all levels, although of course training will vary depending on the level. Whereas, the current guidelines do not make it an essential component, it is sort of left open as an option.

We also suggested there have to be three levels of oversight. The board, as I described.

Senior management has to be given, somebody in senior management has to be given accountability and responsibility for the day-to-day operation of the compliance program.

And, and these were complaints I heard over the years as I tried to revise companies, they be given both the resources and the authority to carry out that responsibility. We heard from many people, very very well intentioned people in responsible for compliance that they were not getting enough resources to do their job.

And then, of course, at the lowest level we have to give employees an opportunity to report violations of law that they may have witnessed both free from retaliation, which is in the current guidelines but we also recommend it. And this is consistent with Sarbanes-Oxley, that a company as part of an effective program set up a means of anonymous reporting so that an employee can at least convey information that needs to be acted on in the most comfortable manner for him so if he's fearful he'll be retaliated against, at least he has this means.

Mr. GREENWOOD. It would seem to me that this almost has to be initiated from the very top or, at least, initiated by the board.

Mr. WALLANCE. Right.

Mr. GREENWOOD. Because if a CEO has a character that isn't the kind that would want to see this kind of compliance, then it seems to me it would a fairly bold thing for an underling to recommend the initiation of this kind of culture, would it not?

Mr. WALLANCE. Yes, I think that is an important point and well worth taking. I think if the company encourages openness and says we have zero tolerance for violations of law and we want employees to report them and you will not be retaliated against, it is likely to elicit the kind of information that I think companies desperately need in order to fulfill their obligations both to the shareholders as well as their obligations imposed by law.

If on the other hand what is communicated, either directly or implicitly is we cut corners, we are more interested in profits, the bottom line counts, do not raise technical legal considerations, then it is not going to get that information and it will end up being, as we have seen in the last year, in the position of many hapless companies and with, unfortunately, consequences really for all of us.

Mr. GREENWOOD. And if it does not come from the management side and if this culture of compliance is to be initiated by the board of directors itself, I mean how would that come to be? I mean, does a new director after being welcomed to the board raise his or her hand and say I would like to initiate a culture of compliance here?

Mr. WALLANCE. Well, I think that ultimately the board has to take upon itself, and that is what we are recommending it be given, the responsibility not for day-to-day management. I want to be careful to draw that distinction. The boards cannot do that. But to make certain that the procedures and controls are in place to give the company as much assurance as possible that it is doing what it needs to do to prevent violations of law. And not only should it do that in the sense of saying let me see your procedures, let me see your personnel handbook, let me see your compliance infrastructure, show me the mechanism you have got for anonymous reporting for hotlines, but it should be out there talking to people. It should be, to some extent, kicking the tires. It should have a regular line of communication with the senior management person who has that day-to-day responsibility and give him a direct reporting line to the board.

And second, and we recommended this, it needs to be out there talking to the people in the field with operational day-to-day responsibility. This does not actually have to be done by the whole board. It can be done by a subgroup such as the audit committee. It does not require an enormous amount of time, but it will require time. It may want to talk to the internal auditors to find out what they are doing.

And just to give you an example of one I encountered, which is a company, let us say, of 30,000 employees, a 100 factories or office locations, has five internal auditors who visit those locations once every 10 years. That suggests that they may not be focusing enough resources on the auditing function. And then the board can say to the management why should we not have more, should we not get more. And I think if management is responsible, they will do something about it.

Mr. GREENWOOD. Have you looked at HealthSouth Corporation enough to have an opinion as to whether the culture of compliance that you have described existed there?

Mr. WALLANCE. I would say this: I am not familiar with the details of how HealthSouth and the governance of HealthSouth, but I will say that it is not rocket science when 15 high level employees including CFOs for the last years all plead guilty to felony conduct in connection with the conduct of the affairs of the company to say this company does not have a culture of compliance with law.

Mr. GREENWOOD. Okay. The report states in part "Ultimately the governing authority is responsible for the activities of the organization. It can only perform this function if its members are actively involved in compliance reviews and reasonably educated about the business of the organization and the legal and fiduciary duties of the governing authority members."

One of the Advisory Committee's proposed changes states: "The organization's governing authority shall be knowledgeable about the content and operation of the compliance program to prevent and detect violations of the law and shall exercise reasonable oversight with respect to the implementation and effectiveness of the programs to prevent and detect violations of the law."

As a preliminary matter does governing authority generally refer to a company's board of directors, is that what you're referring to there?

Mr. WALLANCE. Yes. We had a definition. It means the board or if there is no board, perhaps in a private company solely owned, the highest authority within the company to decide matters of substance for the company.

Mr. GREENWOOD. Okay.

The gentlelady from Colorado is recognized for 10 minutes.

Ms. DEGETTE. Thank you, Mr. Chairman.

Mr. Wallance, you have both served in the criminal arena and now in the civil area. And as I was reviewing your testimony last night it occurred to me these recommendations that the Advisory Commission was preparing were for the Sentencing Guidelines in the criminal arena, is that right?

Mr. WALLANCE. Well, yes.

Ms. DEGETTE. But the same principles I think would apply. I mean, it is not just trying to set a criminal standard, but really it

is trying to say what should the highest and best practices be for board conduct, correct?

Mr. WALLANCE. That is correct. And I would like to point out that when we define a report an effective report to prevent and detect violations of law, we did not limit, and we were quite deliberate about this, the meaning of the term violations of law to criminal violations.

Ms. DEGETTE. Right. Because in fact when you are talking about board conduct, it will be infrequent if ever that you could prove in a criminal court the means required for felony conduct, right? I mean, most of this is taking place not at that kind of level of specific intent, right?

Mr. WALLANCE. It tends to take place at the operational level.

Ms. DEGETTE. Right.

Mr. WALLANCE. But the point is that if a corporation—a corporation cannot deter and prevent violations of criminal law unless it attempts to deter and prevent violations of all law.

Ms. DEGETTE. Exactly. And so what your recommendations are really designed to do is to prevent the kinds of criminal activity that we are seeing with HealthSouth and the indictments we have seen out of that by a best practices kind of system, right?

Mr. WALLANCE. Yes. That is essential.

Ms. DEGETTE. Now, what just occurred to me, though, is having practiced myself both in the criminal and civil realm some years ago, especially with white collar crime, what is really effective in deterring that crime is if the individual has personal exposure, which is in some ways why Sarbanes-Oxley has been so effective not because of all the things we did, but because they have to sign that financial disclosure, the financials, right?

Mr. WALLANCE. Yes. I agree.

Ms. DEGETTE. Do you agree with that?

Mr. WALLANCE. Yes. I think that was one of the innovative features of Sarbanes-Oxley is the notion of personal accountability for the financial reports and disclosure.

Ms. DEGETTE. Right. Because all the CEOs I know are reviewing these things like they never have before, which is good. Even in a company where you do have a good culture, it is important, do you not agree?

Mr. WALLANCE. I do agree with that.

Ms. DEGETTE. Okay. So here's my question to you is what kind of incentive can we give to corporate boards to have the same level of care and concern for all these wonderful things that your Advisory Commission has put in place? What is the incentive for them to actually do this?

Mr. WALLANCE. Well, one of the incentives, and to some extent it exists already, is that if the board fails to adequately supervise the company, and particularly when it comes to legal compliance, it is potentially exposed to shareholder suits. And that was really the teaching of the "Caremark" decision in the Delaware Chancery Court in 1996 which suggested that in so many words that if a company fails to follow the precepts of the organizational guidelines compliance criteria, then the board is not doing its oversight job and could be exposed to shareholder suits. So that is one deterrent.

I also think that a deterrent has been set up in the past 2 years just by the sheer immensity of the scandals, their devastating impact on individuals, the publicity and so on.

I do think that these kinds of hearings will also contribute to that.

Ms. DEGETTE. I cannot help but think back to the boards I have worked with in my life and, I am not sure before the last few years and the congressional hearings and Sarbanes-Oxley and everything, really corporate board members really understood what their role was. Would you agree with that?

Mr. WALLANCE. Well, not entirely. I do think that the vast majority of boards and companies in America are well intentioned to take their responsibility seriously. I think that over the last 10 years because of the Organizational Sentencing Guidelines there has been a growing awareness of the need for compliance. We have witnessed it. It is laid out in our report, quotes from various people about just how 10 years ago there was not a field of corporate compliance.

I think that we are always going to have people who do not take the responsibility seriously or worse. All we can do is try to put in place as many incentives as you're suggesting as we can to defeat it to deter them from doing that kind of either malfeasance or misfeasance.

Ms. DEGETTE. But I mean even though people have been aware of these guidelines, I am not sure people have really necessarily understood what their role is as a board member to implement them, and especially in some of the high profile situations we have had.

I have sat here and we have done Enron and Qwest and Tyco and on and on and on. And the theme that runs through it besides the evil doers at the top of the corporate management is boards, many of the board members have been well meaning, but they just did not understand. And they knew their role was to have oversight, but they did not understand how to accomplish that.

Mr. WALLANCE. Well, I agree that more needs to be done. And we perceive of the absence in the guidelines of any recognition of the role and responsibility of the board as something that needs to be addressed.

Ms. DEGETTE. Have you had time, I know it is short notice, to review the new SEC rules that were adopted by the New York Stock Exchange and NASDAQ about the strengthening of corporate governance standards? This just happened yesterday.

Mr. WALLANCE. I have not. But I was somewhat familiar with the proposals before they were adopted.

Ms. DEGETTE. And do you think that is going to help this along?

Mr. WALLANCE. Yes, I think it will. I think the notion of compliance that address the high level officers, among other things, I think all of them are very needed and necessary.

But let me explain, what we were trying to do in this report and recommendations was pull all of this together. It was not so much that we have invented something new under the sun. But I think we have taken from Sarbanes-Oxley, from the experience of the last 10 years, from the experience learned in these scandals, from

the regulatory changes and the SOR changes and put it all in one place for the guidance of companies.

Ms. DEGETTE. And I think that is excellent guidance. But I also think that if you have rules that are being required by the SEC and other governing entities, that might put some legal teeth behind the recommendations you are making.

Mr. WALLANCE. On that I completely agree. Because ultimately what these guidelines are voluntary.

Ms. DEGETTE. Right. That is what I am trying to say.

Mr. WALLANCE. A corporation is not legally obligated to adopt them. So to the extent they are embedded in law and regulation, then obviously they will have that much—

Ms. DEGETTE. They will be that much more effective because companies will have not just a recommendation, they will have a requirement they have to abide by.

Now your report recommends that a company should do proactive monitoring and auditing of its own compliance and audit programs to see if they actually work instead of just having a compliance officers and internal auditor make periodic reports. How should that be carried out and who should do that?

Mr. WALLANCE. Well, we suggested that it could be done by a subgroup, it could be the audit committee, particularly one that may have independent directors on it. And we envision that they would hear from persons involved in compliance periodically as to the nature, the progress, the success of the compliance program without the sort of the potential censoring or filtering that senior managers might bring to that process.

Ms. DEGETTE. Right.

Mr. WALLANCE. So that is one way.

The other is to talk to people in the field. And I think they have to become familiar with both the compliance program in some detail as well as the business activities that may expose the company to risk, and what is being done to avoid that kind of risk.

Ms. DEGETTE. Now, in this case in 1999 there was a major allegation of fraud by the top officers of the company. And that turned out to be accurate, by the way. But it was submitted to HealthSouth compliance officer. There was no evidence that the compliance officer ever investigated the allegation and the complainant was told that she needed to be placated.

What type of structure could you put into place in that type of situation to give that compliance officer more authority and independence?

Mr. WALLANCE. I am not in a position to comment on that specific situation.

I would say as a general rule it has to be made clear, including by the board in various written statements, that reports of wrongdoing need to be investigated. It doesn't mean that people are presumed to be guilty before any investigation has taken place. But when senior compliance officers receive reports of wrongdoing, they need to be examined and investigated and appropriate response implemented.

Ms. DEGETTE. And I would think it would be helpful also if there were some kind of outside person that the compliance, either inde-

pendent director or someone on the board, they could go to if they were not getting that kind of response internally.

Mr. WALLANCE. Well, one thing many companies are doing is providing separate outside counsel to the audit committee or to, in effect, a litigation committee depending on the circumstances so that that committee if it receives reports of potential wrongdoing can have its own legal advice as to how to respond to it.

Ms. DEGETTE. And those would be outside counsel with no other conflicts, no other engagements with the company, correct?

Mr. WALLANCE. Yes. I think in general what you're now getting into is how internal investigations need to be conducted.

Ms. DEGETTE. Right.

Mr. WALLANCE. And I can respond, perhaps, on that subject briefly, which is I do think having done them, that it is important to preserve the credibility of the investigation. That it be done in a way that does not leave any question as to whether things were not done because of potential—

Ms. DEGETTE. You know, my time has expired. And I appreciate it. If we have some time for a second round, I will come back to that.

Thank you.

Mr. GREENWOOD. The gentleman from Oregon, Mr. Walden, is recognized for 10 minutes.

Mr. WALDEN. Thank you, Mr. Chairman.

I guess my first question is do you think that there is an adequate mechanism in place for people who decide to represent shareholders on a board to be trained in their responsibilities? How do you ever as a board member know all these rules and regulations?

You are off running your company and somebody says to you that would be a great addition to our board. Let us see if they run, and they do and they show up. And you have got a domineering CEO that is quite successful and does all these sort of strange things to board members, including having his own security person follow him around.

My question is as a perspective board members, how do you know what you are supposed to look for and is there any need for some sort of requirement of training?

Mr. WALLANCE. Well, we did recommend that there be training at all levels of the company. We did not exclude the board. Now, obviously the training for the board is going to be a little bit different than the training for the plant manager.

Mr. WALDEN. Yes.

Mr. WALLANCE. But there is no reason why a board cannot insist on having the general counsel or the head of compliance walk it through the compliance program in some detail just the way it has presentations on the company's financial statements. It does not mean it has to read every law or regulation. There is a supervisory component to this. But it can be proactive in getting information that would allow it to judge whether processes and controls are properly being implemented through a sure compliance with law.

Mr. WALDEN. But what if that board relies on an outside auditors to evaluate those controls and that outside auditors says the controls in place are permissible?

Mr. WALLANCE. Well, there is no question that a board is ultimately going to have to rely on the outside auditor. The outside auditor is not doing his job, all right, absent some red flags that the board perceives, then the system may break down.

But I do think that the board has to be alert. I think this is the teaching of these scandals is that the board has to be alert to potential red flags that would indicate there may be a conflict of interest. For example, transactions with no apparent economic substances.

Mr. WALDEN. Right.

Mr. WALLANCE. Asking questions, why are we doing this if there is no economic substance. What is the business purpose behind this. Asking those kinds of questions in the course of receiving information about the company's business operations, I do think is a responsibility of a board to act on, again, these kinds of red flags.

Mr. WALDEN. If an auditor's report showed that year after year there's a red flag that came that said management is too strong over the board, should that: (a) be reported to the board and if so, what should be done about it?

Mr. WALLANCE. I honestly have not encountered that kind of a management letter from an auditing company. Assuming it was somewhat specific about why that created governance issues, then yes. If that comes to the attention of the board, they need to look into it and decide whether any particular remedial action is called for.

Mr. WALDEN. How should an auditor handle a situation where somebody sends them an email, their name, address on it says look at these specific issues within this company. I think there is a problem, and they are very specific in where to look?

Mr. WALLANCE. I think it needs to be acted on and investigated. There are a number of instances where it was that kind of an anonymous note that was received either within management or by an accounting firm that ultimately led to the uncovering of serious problems. And to the extent that there is enough detail to follow up and it presents at least on its face an issue of concern, then it needs to be investigated.

Mr. WALDEN. What would be the appropriate response? If you were the outside auditor and you got an email like that on a company you were responsible for looking at, what would the steps be you would take?

Mr. WALLANCE. Well, I am not an outside auditor. I am an attorney. I would just suggest that I think it would be the auditor's responsibility to make certain it is brought to the attention of somebody within the company who has the discretion and the authority to act on it, to then take it and deal with it in an appropriate way.

Mr. WALDEN. Would it also be a recommendation that the auditor would go back to the person making the claim?

Mr. WALLANCE. Well, again, you are now asking me for standards governing the conduct of auditors, which is somewhat outside of my expertise.

I think just in general I would say the organization needs to follow up on that kind of information. And there is some very practical reasons why. Because if it does not, the next place that any-

mous note or letter may go to is "The Wall Street Journal." And, if it does not go there, it may go to the U.S. Attorney's Office.

So, hopefully, at the end it is not so much—and this is part of it—that it is just that companies should want to be good corporate citizens. That is certainly a part of it, they should be. But there is a very practical self interest in getting on top of these kinds of problems at the earliest possible time when the company will have the most options available to it to deal with those problems.

Mr. WALDEN. It appears in the case that we are reviewing here, HealthSouth, that the people who were aware of potential problems or alleged frauds were reporting to their compliance officers who were apparently also involved in the fraud. How do you get around that on a governance issue and does Sarbanes-Oxley do that with the outside whistleblower protections and things of that nature?

Mr. WALLANCE. It helps. Okay. All of these things help at the end of the day. Will any of these programs prevent, and again I am not referring to HealthSouth.

Mr. WALDEN. That is fine.

Mr. WALLANCE. But a determined effort, a conspiracy if you will, by senior management including the people in charge of compliance to avoid the law? No. At the end of the day it will not. Some of these things are going to occur regardless of our best efforts. What we can do is try to deter and prevent these sorts of things from happening.

Mr. WALDEN. Do you see any remaining gaps out there after we pass Sarbanes-Oxley? Is there something that has come forth since then that causes you to say, gee, you ought to look here, change this?

Mr. WALLANCE. Well, I think to the extent there are any gaps, I would like to think that the Ad Hoc Advisory Group's report fills them. But I want to stress, we were guided in large part by Sarbanes-Oxley.

Mr. WALDEN. Right.

Mr. WALLANCE. And the other regulatory measures that have been enacted in the last 2 years.

Mr. WALDEN. Right.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. GREENWOOD. And the Chair thanks the gentleman.

The gentleman from Florida is recognized for 10 minutes.

Mr. STEARNS. Thank you, Mr. Chairman.

And, Mr. Wallance, as I understand your background you were a prosecuting attorney on white collar crime?

Mr. WALLANCE. Yes, that is correct.

Mr. STEARNS. And then you were a litigator on the private side?

Mr. WALLANCE. Yes, that is what I currently do.

Mr. STEARNS. And have you ever been on a board of directors?

Mr. WALLANCE. No, I have not.

Mr. STEARNS. Okay. So this information is pretty much just from your perspective as a litigator?

Mr. WALLANCE. Well, it is partly from my perspective as a litigator, partly from my experience in prosecuting corporations as a prosecutor. And from participating in such activities as this Ad Hoc Advisory Group.

Mr. STEARNS. Give me a definition of what a proactive board of directors? I mean, just maybe one or two sentence what the definition is proactive?

Mr. WALLANCE. They do not wait to be told what is happening.

Mr. STEARNS. Okay.

Mr. WALLANCE. They ask, and go out and find out what is happening in their company.

Mr. STEARNS. Okay. At what point should a board of director ask for forensic accounting audit? What flags do they have to see forensic, you know, find out something is not right, we are getting letters saying there is fraud? I mean, they had letters going back to—I have one here from November 12, 1998 from a “fleeced shareholder.” It could be anybody.

But what is the thing that triggers in their mind that?

Mr. WALLANCE. Well, there is no hard and fast rule. I cannot give you golden rule for triggering a forensic audit.

I think the company has to receive some kind of substantive information that would appear to either be credible or derived from some reliable source that suggests that there is a potential for a violation of law, and then act on that. Whether a forensic is required may not be apparent immediately. You may have to do some initial investigation. And at a certain point if the concerns appear serious enough, and again there is no—

Mr. STEARNS. Hard and fast is what you are saying?

Mr. WALLANCE. Just generalizations, then it may be appropriate to have that kind of level of scrutiny.

Mr. STEARNS. If this board was proactive and they had some concern, I think you have indicated they should meet with members of the company’s internal audit department?

Mr. WALLANCE. I want to be careful. We did not try to be prescriptive, that prescriptive in our—

Mr. STEARNS. Well, just let me ask you personally. If a company, the board of directors had some indication that there was a problem, should they in your definition of being proactive meet with the company’s internal audit department?

Mr. WALLANCE. If I were sitting on an audit committee of a board of directors—

Mr. STEARNS. Right.

Mr. WALLANCE. [continuing] and an issue arose that required or should have been looked at by the internal auditors or was, yes, I would meet with them.

Mr. STEARNS. Okay.

Mr. WALLANCE. I would go talk to them.

Mr. STEARNS. Okay.

Mr. WALLANCE. And ask them what are you doing about this or what are you doing about complying—

Mr. STEARNS. So we have a Board of Directors right behind you. So they have to say in their mind there was enough for me to say to the Chairman of the Board we should sit down and meet with the internal audit department. And so in your own estimation that is what the normal reaction if they have any apprehension?

Mr. WALLANCE. Again, I am not in the position to address HealthSouth specifically.

Mr. STEARNS. Oh, no, I understand. But in a generic sense you are saying yes?

Mr. WALLANCE. But, yes depending if there is a serious issue that the internal auditors knew about or should have known about, then there really is no reason why a proactive audit committee would not hear from the internal auditors.

Mr. STEARNS. Okay.

Mr. WALLANCE. Again, it is very case-by-case specific.

Mr. STEARNS. If I went to the Fortune 500 companies, how many of those board of directors are defined as proactive in your opinion? I mean, just approximately? Most of them or none of them?

Mr. WALLANCE. I could not—I would not—

Mr. STEARNS. You would not venture a guess?

Mr. WALLANCE. I would not want to give you an opinion having not done a survey.

I will point out that in the last week or 2 there was an article in “The Wall Street Journal” about how much more time board members are devoting to their duties. Again, I think the vast majority of board members in this country are responsible. I think they will be more active than ever, as suggested by this “Wall Street Journal” article as a result of these scandals.

Mr. STEARNS. Yes.

Mr. WALLANCE. But we have work to do.

Mr. STEARNS. Okay. So let us say we have this proactive board of directors and under your guidelines there is some flags. So they sit down and they say okay, we want to meet with the internal audit department. Okay. So under your definitions that is what they do.

They sit down with the internal audit department and they find out that the internal audit department did not have access to the company’s corporate books and records. What would that mean to you?

Mr. WALLANCE. Well, it would suggest potentially there has been a breakdown of governance in at least that respect. The way you present it, yes, if the auditors need those books and records to do their job and they’re not getting them, that is a problem that needs to be addressed.

Mr. STEARNS. Let me ask you about the composition of a board of directors. You know, generally what happens these board of directors are distinguished men and women in various fields and they are friends of the CEO, and they are selected. In your opinion is there an importance to the composition of the board? Is that significant?

Mr. WALLANCE. Yes, I think it is but we did not try to address that in the report. What I will point out is that there has been legislation and regulation which addresses the need for independent board of directors including independent members of that board, including on the audit committee.

There is also, you know, a very health debate about what size the board to be; too small or too big is not desirable. There is, you know, an argument that it should be a certain size. I do not really have views on those. Those are the sorts of things that we have left, again in our report, to the judgment of companies and boards to make as to how, in effect, organize themselves.

Mr. STEARNS. You mentioned the three levels of authority earlier. You talked about the board, senior management and then the employees to be able to whistleblow. I think those are the three you mentioned. And you said in each case they must have the resources and authority to act.

How do you provide a climate that people feel free to be “a whistleblower” or to go forward and say hey something is wrong here? Because we have seen from the previous hearings we have had like Ms. Watkins and others, that even when they lay it out, A to Z, it is all covered up.

Mr. WALLANCE. Well, let us distinguish between the reporting and then the acting on the reporting.

To encourage the reporting—

Mr. STEARNS. Right. That is good.

Mr. WALLANCE. [continuing] there are a variety of ways, and companies have been incredibly creative in the last 10 years through training programs, dissemination of written materials, personnel handbooks which employees are obligated to read and sign that they have read, which all lay out the company’s commitment to compliance with law and give them means to report with assurance of no retaliation which is now codified in Sarbanes-Oxley.

Mr. STEARNS. Right.

Mr. WALLANCE. And as we have suggested, anonymous reporting. But I think that if that commitment is communicated in sincere fashion from the highest levels of the company we want you to talk to us, we want to know what is going on, I think it will get the reporting in needs.

Mr. STEARNS. In Tab 72 of our reports there is this memo from a “fleeced shareholder” to HealthSouth as well as Ernst & Young. And, frankly, in his roughly 250 words he lays out the whole problem. And this was November 12, 1998. So 5 years ago. And he talks about the clever tricks that are being used to pump up the numbers. He says something that a novice accountant could catch, but is not being caught. He talks about the balanced budget amendment was passed and the impact it would have in Medicare, and how is HealthSouth management being effected by the balance budget amendments cutback. And they cannot possibly be doing as well as they say. And does anyone believe their nonsense about managed care pressure. And then he has even little things like how can the company carry tens of millions of dollars in account receivable that are well over, I think it says 360 days or something.

But this kind of memo comes up.

Now, the Board of Directors would never know about this. This could go to HealthSouth, or it could go to Ernst & Young. And how do you protect this kind of information, say, this could be a shareholder but it probably is an employee of HealthSouth? Because to have this kind of detail that they know, I do not think is a shareholder. I think this is somebody inside. So, I would think this would be sort of a miniature whistleblower. And how you get this information so it is promulgated to the Board of Directors, and how do you get Ernst & Young to act on it?

Mr. WALLANCE. Well, we suggest that there needs to be three levels of corporate compliance responsibility. And, hopefully, you are right, you would not expect that to get to the board. You would

hope that it would be brought to the attention, if the procedures are working correctly, to at least the first or second level. The day-to-day or they hope the person with overall responsibility. If you have responsible people in those positions, they will act on it. It does not mean they have to hire an outside law firm and start an internal investigation or hire forensic accountants. But they will want to follow up and find out if there is any substances to this. And depending on what they find out, they can either bring it to the attention of the board and recommend that various measures be taken, or they are satisfied that it does represent, let us say, a crank there is no substance. Then if they have satisfied themselves, then maybe no further action is needed.

But the board cannot do it all. I do not want to suggest that.

Mr. STEARNS. No, I know. It has got to be a team effort.

Mr. WALLANCE. Yes. Exactly.

Mr. STEARNS. Thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentleman.

Before we dismiss you, Mr. Wallance, one further question. Ms. DeGette had a question on the table and we are both just interested in your response as to how you would set up an independent examination of the kind that this company did, and what you would do, what your recommendations would be to a company that wanted to set up a truly independent outside review?

Mr. WALLANCE. Yes. I think we are now talking about internal investigations, which we touched on earlier. I think a company needs to—I think in general it would want to hire an outside law firm. There is some debate, you know, in the literature about whether it can do it itself or not. But I think it has to be guided by this principle, which is if it undertakes an internal investigation, the investigation has to be done credibly. And the best way to assure credibility, the appearance of credibility is to hire outside disinterested law firms and accounting firms, again depending on the circumstances, to conduct an independent investigation and give the board or the appropriate subgroup or the next level of compliance responsibility the unvarnished results of its investigation so that the company can act responsibly on those results.

Mr. GREENWOOD. And suppose that that outside law firm is retained to do the internal examination and then subsequent to that, defend the company? Can there be anything approximating an independent examination if they have the expectation that they may or may not continue to be retained for purposes of defense work?

Mr. WALLANCE. You know, that is a harder question to answer. The one that typically comes up is not so much when the outside law firm represents the company in the ensuing investigation, if there is one. And it may make a lot of sense for it to do so, because it is familiar with facts. If it was a credible law firm, then it may be the best firm to deal with, for instance, investigators.

Typically where the issue comes up is when you hire a law firm that has ongoing work, is doing ongoing work, especially if the work that it is doing is the subject of the investigation. Then I think the company has to ask itself, okay, are we going to assure, you know, as great an opinion we have of these lawyers, as well suited as they may to do this investigation, are we going to assure

the appearance of credibility or would it be better to hire a law firm, or at least one that has not done work in that area that is the subject of the investigation.

Mr. GREENWOOD. And are there circumstances under which you would think that that credibility could be maintained if the subject of the investigation, the CEO for instance, had access to that report before it was published?

Mr. WALLANCE. Well, that's another, that is a very tricky area. And if I may, it is—

Mr. GREENWOOD. Before it was published or before it was even presented to the board?

Mr. WALLANCE. And again, here is the thing and I have lectured on this, I have set up hypotheticals based on it, there is no real clear answer. You are sort of caught between two issues.

First of all, the people managing the company do need to know something about what is going on and the fact of the internal investigation and what its findings are. On the other hand, if the people managing the company's conduct, if their conduct is the subject of the investigation, then you have the problem with the appearance of credibility.

There is no easy answer. It is one of the most difficult I know.

One solution that has been suggested is you do inform the person whose conduct is at issue, but who is also a manager of what is going on, but then suggest that he not be involved in the day-to-day running of the internal investigation. And that to the extent he receives information, he receives information at the same time independent directors receive it. That has been one suggestion.

Every case is different. It is an exquisitely difficult issue for an outside lawyer advising a company under those circumstances. And you have identified a very, very real issue for internal investigations.

Mr. GREENWOOD. Well, we thank you again. You have helped set the standards that will guide us in the rink throughout the rest of the hearing today, and we appreciate that.

Mr. WALLANCE. Well, thank you for the opportunity.

Mr. GREENWOOD. Okay. You are dismissed, sir.

And we now call forward our second panel, consisting of Mr. Joel Gordon, Acting Chairman of the Board of Directors of HealthSouth Corporation; Mr. Robert May, Acting Chief Executive Officer of HealthSouth Corporation; Ms. Sage Givens, Board of Director and Audit Committee Member of HealthSouth Corporation.; Mr. Larry Striplin, Board of Director and former Chairman of Compensation Committee for HealthSouth Corporation, and; Dr. Phillip Watkins, the former member of the Board of Director and Compensation Committee Member for HealthSouth Corporation.

You may be seated.

Welcome, and we thank you all for your attendance here this morning.

It is my responsibility pursuant to the Rules of the Committee to inform you that because this is an investigative hearing, we take our testimony here under oath. And so I need to ask if any of you object to giving your testimony under oath this morning. Seeing no objection, I also would inform you that you are entitled to be rep-

resented by counsel. And would ask if any of the witnesses wish to be represented by counsel.

Mr. Gordon, do you, sir?

Mr. GORDON. Yes, I do.

Mr. GREENWOOD. And would you identify by name and by pointing to your counsel, please?

Mr. GORDON. Yes. Pointing to No. 1, Mr. Bob Bennett, who is counsel for the corporation and Mr. Mike Madigan, who is counsel to the Board.

Mr. GREENWOOD. Thank you, sir.

Ms. Given, are you represented by counsel this morning?

Ms. GIVENS. Yes, I am. It is the same two gentlemen.

Mr. GREENWOOD. Same two gentlemen?

Dr. Watkins?

Dr. WATKINS. Same two gentlemen.

Mr. GREENWOOD. Mr. Striplin?

Mr. STRIPLIN. Same two gentlemen.

Mr. GREENWOOD. Mr. May?

Mr. MAY. Same two gentlemen.

Mr. GREENWOOD. How efficient. Very good.

I would ask now that if you would stand and raise your right hands, please.

[Witnesses sworn.]

Mr. GREENWOOD. Okay. You each under oath. And are now welcome to give your opening statements.

Mr. Gordon, do you have an opening statement?

Mr. GORDON. Yes, I do.

Mr. GREENWOOD. Okay. You are recognized for 5 minutes to give that opening statement. I suggest that you pull your microphone a little bit directly to you, and make sure it is on. And we would look forward to your statement, sir.

**TESTIMONY OF JOEL GORDON, ACTING CHAIRMAN, BOARD OF DIRECTORS, HEALTHSOUTH CORPORATION; SAGE GIVENS, BOARD OF DIRECTORS AND AUDIT COMMITTEE MEMBER, HEALTHSOUTH CORPORATION; PHILLIP WATKINS, FORMER MEMBER OF THE BOARD OF DIRECTORS AND COMPENSATION COMMITTEE MEMBER, HEALTHSOUTH CORPORATION; LARRY D. STRIPLIN, BOARD OF DIRECTORS AND FORMER CHAIRMAN, COMPENSATION COMMITTEE, HEALTHSOUTH CORPORATION; AND ROBERT MAY, ACTING CHIEF EXECUTIVE OFFICER, HEALTHSOUTH CORPORATION**

Mr. GORDON. Mr. Chairman, ranking member, and members of the subcommittee, good morning.

My name is Joel Gordon and I am Interim Chairman of the HealthSouth Board of Directors, having been appointed Interim Chairman on March 19, 2003. On behalf of the entire HealthSouth team and our more than 48,000 employees throughout the country, I appreciate the opportunity to appear before the subcommittee.

As yesterday's indictment of Richard Scrushy, the former Chairman and CEO, indicates, Mr. Scrushy, along with former members of management, directed a massive accounting fraud at HealthSouth. The Department of Justice has charged that they not only defrauded the company and its shareholders, but also the

Board of Directors. I look forward to answering your questions and describing the progress that the Board and the company have made over the past 7 months in stabilizing our business since the massive accounting fraud first came to light.

As you may know, HealthSouth is a leader in inpatient and outpatient rehabilitation, diagnostics and outpatient surgery. In its short history, HealthSouth has grown to become the Nation's largest provider of healthcare services, with nearly 1,700 locations throughout the country and abroad, and more than 48,000 employees. With our broad network of outstanding facilities, highly skilled physicians and therapists, and state-of-the-art technology and equipment, we are able to provide all of our patients easy access to high quality healthcare.

Since March 2003, when we were first made aware of the allegations of accounting fraud, the company and its new management team have actively cooperated with, and assisted to the best of our abilities, all government inquiries so that the people who committed this fraud can be brought to justice. We did this because it is the right thing to do—and it is in that same spirit that I and my fellow board members have come here today to answer your questions.

HealthSouth's public stockholders have clearly been harmed by the fraud, and I can assure you that I understand very well the frustration and outrage of shareholders who have lost value in the company's stock. My family and I have been, and continue to be, the largest non-institutional stockholder in HealthSouth. I acquired these shares when I sold my company, Surgical Care Affiliates, to HealthSouth in 1996 in an all stock deal, and I have held on to virtually all these shares—over 99.9 percent.

My family currently owns 9.5 million shares and I have options on an additional 500,000 shares that came from the acquisition of Surgical Care, which is the result of a lifetime of work. The value of my shares has shrunk from a high of approximately \$290 million to a very small fraction of that today, the largest loss of any individual shareholder. But, I am determined to build HealthSouth back to a respected position in the healthcare community and to help restore value for our stakeholders.

When the accounting fraud first was disclosed last March, the HealthSouth Board took quick and decisive action. We put Mr. Scrushy on an immediate leave of absence and installed a new leadership team. Shortly thereafter, Mr. Scrushy's employment agreement was declared null and void.

We assembled a first-rate team of experienced outside advisors to help the company through this crisis. We hired PricewaterhouseCoopers to conduct a forensic review and terminated our relationship with Ernst & Young as our auditors. We also retained Skadden Arps as our coordinating legal counsel to assist us. And we brought in the firm of Alvarez & Marsal for their financial and operating restructuring expertise.

Immediately we began implementing measures to stabilize the company's operations, without disrupting the most critical part of our business; patient care. We have been able to make steady progress in each of our primary goals of protecting our core clinical and patient needs, improving and strengthening our cash-flow, and

restoring the company's financial credibility. While there is much work to be done, we are seeing real and measurable success day in and day out.

In addition to assisting with all government inquiries, we recognize that many of our stakeholders; stockholders, bondholders, suppliers, employees, and patients have been hurt by the actions of the people who committed the fraud and we are doing everything possible to rectify that.

On a business level, we have been working diligently to meet our financial obligations, and to restore the company's credibility with our stockholders and the investing public. In mid-August, HealthSouth, a company that most people in the early weeks predicted would file for bankruptcy protection, made a payment of \$117 million representing all past due interest owed our creditors. On October 1, the regular scheduled semi-annual interest payment due our bondholders of approximately \$40 million was made. We intend to remain current on all upcoming interest payments, and to repay all the principal amounts in full.

The progress we have been making over the past 7 months in our business is due in large part to the hard work and dedication of our thousands of employees throughout the country, and I would like to take this opportunity to thank them. They have remained focused on their work and have not let the wrongdoings of a small group of individuals derail the future of our company. Without this commitment to delivering outstanding care to our patients each and every day, the recent success at HealthSouth would not have been possible.

As the son of an immigrant who grew up in a coal mining community of 600, I understand hard work and the commitment it takes to ensure success.

To underscore my commitment to these employees and stockholders, I have chosen to defer receipt of any salary as Interim Chairman until the company's recovery is stable and secure, and the company is on a solid financial footing.

I have also voluntarily canceled the consulting agreement I had as a result of selling Surgical Care Affiliates to HealthSouth in 1996.

Let me conclude by saying that throughout my 7 years of service to the Board, I believe I have exercised independent judgment in all matters. As a major shareholder, I am outraged by the conduct of this company's former management, who successfully concealed thousands of fraudulent accounting entries from Ernst & Young and the Board, to the detriment of all HealthSouth stakeholders.

The Board and management team remains committed to taking the necessary action to ensure that we reach the goal of restoring the long term health and vitality of HealthSouth.

Mr. Chairman, I will, to the best of my ability, be glad to answer any questions you or other members of the subcommittee may have.

[The prepared statement of Joel Gordon follows:]

PREPARED STATEMENT OF JOEL GORDON

Mr. Chairman, Ranking Member, and members of the Subcommittee, good morning.

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Mr. Chairman, I will, to the best of my ability, be glad to answer any questions you or other members of the Subcommittee may have.

Mr. GREENWOOD. Thank you, Mr. Gordon. We appreciate that.  
Ms. Givens.

#### TESTIMONY OF SAGE GIVENS

Ms. GIVENS. Good morning, Mr. Chairman.

Mr. GREENWOOD. Good morning.

Ms. GIVENS. Ms. DeGette, and members of the subcommittee.

My name is Sage Givens. I am a member of the Board of Directors of HealthSouth. I am the Founding Managing Partner of Acacia Venture Partners, which was the first venture capital firm to specialize in healthcare services. Since 1983 I have helped many leading healthcare services companies from the ground up by providing badly needed capital. Like HealthSouth these companies have been successful because they provide millions of Americans with high quality healthcare at affordable prices.

I joined HealthSouth's Board of Directors in 1985, when my firm First Century Partners invested in the company. After the company went public in 1987, I was annually re-elected to the HealthSouth Board by shareholders. I have remained on the Board because I believe so strongly in what HealthSouth stands for; high quality, affordable healthcare.

The HealthSouth Board over the years has included many distinguished and accomplished individuals. This Board has also surrounded itself with experts in the fields of finance, compensation, financial reporting, compliance and ethics. The Board was regularly briefed by nationally recognized firms such as Ernst & Young, Mercer Human Resource Consulting, Strategic Management Systems, and many others.

Although we do not have the details of how this fraud occurred, what we have learned so far is that it was a very carefully orchestrated, highly sophisticated accounting fraud, designed to evade detection. Indeed, at HealthSouth we had numerous controls and systems in place that should have helped to detect this fraud. Unfortunately, when high-level management conspires to commit a criminal act, I do not know of any corporate governance policy that would prevent such criminal behavior. From the beginning, I have been a vigilant, active and well prepared Board member. I have asked the tough questions and have been unafraid to express my

thoughts forcefully. Any implication to the contrary is just plain wrong and goes against my reputation for being a tough but fair-minded director of numerous companies over the years, both public and private.

It is difficult to convey how shocked and saddened I have been since learning of the fraud committed against the company. After all, it was touted by many one of the best rehabilitation companies and the first healthcare company to establish itself in all 50 states. It was associated with numerous world-class physicians and established a preeminent reputation in the treatment of sports injuries, cardiac and stroke patients, and was endorsed by prominent figures in many walks of life.

Now I would like to take the opportunity to address the subject of the audit committee which was discussed during the first day of your hearings, Mr. Chairman. I have been a member of the audit committee since 1989. Early on, the company selected Ernst & Young, one of the most highly experienced and nationally recognized accounting firms in the country.

The audit committee met regularly and was often joined by representatives of Ernst & Young. Detailed questions were asked of Ernst & Young at these meetings about the company's finances and we were regularly assured that the company's accounting practices and internal control systems were among the best in the country.

Audit committee members, as well as other Board members, queried Ernst & Young about any and all accounting deficiencies to be addressed and corrected. None, not one, was ever raised by the auditors in the 13 plus years I served on the audit committee. Indeed, in Ernst & Young's Management reports for the last 3 years, the auditors declared that they found "no material errors, fraud, or possible material illegal acts."

Finally, I would like to respond to questions about business relationships with HealthSouth that are described as "Related Party Transactions." As you know, Federal securities law contemplates and permits such transactions.

I am a venture capitalist and I specialize in the healthcare industry. My job is to find new and innovative companies which can deliver superior healthcare services at affordable prices to all Americans. When I found examples of companies which provide good medical care at affordable prices, I not only invested my company's capital in those companies, but I thought it made good sense to share those opportunities with HealthSouth. Sometimes HealthSouth thought it was in the company's and its shareholders' best interests to invest and it did so. And more times than not, HealthSouth declined to make an investment.

There is not one example of a time when I or my firm pressured HealthSouth to make an investment. In virtually all of those transactions, HealthSouth and its shareholders have benefited.

HealthSouth, despite the enormity of the malfeasance committed by a few individuals, has clearly contributed a great deal to the healthcare industry. The fact that the company is still standing strong and has staved off bankruptcy is a testament to its employees and the quality of medical care it has provided to millions of patients. Indeed, I believe that with the dedication and leadership of the Board and the new management team, HealthSouth will con-

tinue to make an enormous contribution to medical care in this country. My focus as a Board member has always been, and continues to be, to ensure HealthSouth's future as a viable, strong and ethical business.

Thank you.

[The prepared statement of Sage Givens follows:]

PREPARED STATEMENT OF SAGE GIVENS

Mr. Chairman, Ranking Member, and members of the Subcommittee, good morning.

My name is Sage Givens. I am a member of the Board of Directors of HealthSouth. I am the Founding Managing Partner of Acacia Venture Partners, which was the first venture capital firm to specialize in healthcare services. Prior to that, I was a principal at First Century Partners, where I managed the firm's healthcare practice. The venture funds with which I have been associated have helped build many leading healthcare service companies from the ground up by providing badly needed capital to help them get started and to grow. Like HealthSouth, these companies have been successful because they provide millions of Americans with high quality healthcare at affordable prices.

I joined HealthSouth's Board of Directors in 1985, when First Century Partners invested in the Company. As a condition of its investment, First Century required a seat on the Board, and my partners selected me to fill that seat. At that time, HealthSouth was a private company with only 2 facilities and less than \$2.0 million in revenues. After the Company went public in 1987, I was annually re-elected to the HealthSouth Board by shareholders. I have remained on the Board because I believe so strongly in what HealthSouth stands for—high quality, affordable healthcare.

The HealthSouth Board over the years has included many distinguished and accomplished individuals. This Board has also surrounded itself with experts in the fields of finance, compensation, financial reporting, compliance and ethics. The Board was regularly briefed by nationally recognized firms such as Ernst & Young, Deloitte & Touche, Mercer Human Resource Consulting, Strategic Management Systems, and many others.

Although we do not have all of the details of how this fraud occurred, what we have learned so far is that it was a very carefully orchestrated, highly sophisticated accounting fraud, designed to evade detection. Indeed, at HealthSouth we had numerous controls and systems in place that should have helped to detect this fraud. Unfortunately, when high-level management conspires to commit a criminal act, I do not know of any corporate governance policy that would prevent such criminal behavior. How to prevent this type of fraud in the future is certainly a challenge for boards all across this country.

As long as I have served on this Board, I have strongly believed that this was a company which simultaneously rewarded its shareholders while providing outstanding service to hundreds of thousands of patients per year. From the beginning, I have been a vigilant, active and well-prepared Board member. I have asked the tough questions and have been unafraid to express my thoughts forcefully. Any implication to the contrary is just plain wrong and goes against my reputation for being a tough but fair-minded director of numerous companies, both public and private.

It is difficult to convey how shocked and saddened I have been since learning of the fraud committed against the Company. After all, HealthSouth was touted by many as being a premier healthcare company. It was the first and best national rehabilitation company and the first healthcare company to establish itself in all 50 states. It was associated with numerous world-class physicians and established a preeminent reputation in the treatment of sports injuries, as well as of cardiac and stroke patients, and was endorsed by prominent figures in many walks of life.

I would like to take the opportunity to address the subject of the Audit Committee which was discussed during the first day of your Hearings, Mr. Chairman. I have been a member of the Audit Committee since 1989. Early on, the Company selected Ernst & Young, one of the most highly experienced and nationally recognized accounting firms in the United States. The Audit Committee met regularly and was often accompanied by representatives of Ernst & Young. Detailed questions were asked of Ernst & Young at these meetings about the Company's finances and we were regularly assured that the Company's accounting practices and internal control systems were among the best in the country.

Audit Committee members, as well as other Board members, queried Ernst & Young about any and all accounting deficiencies to be addressed and corrected. None, not one, was ever raised by the auditors in the 13+ years I served on the Audit Committee. Indeed, in Ernst & Young's Management Reports for the last 3 years, the Auditors declared that they found "no material errors, fraud, or possible material illegal acts."

Finally, I would like to respond to questions about business relationships with HealthSouth that are described as "Related Party Transactions." As you know, federal securities law contemplates and permits such transactions. I am a venture capitalist and I specialize in the healthcare industry. My job is to find new and innovative companies which can deliver superior healthcare services at affordable prices to all Americans. That is why my company invested in HealthSouth to begin with. When I have found examples of companies which provide good medical care at affordable prices, I not only invested my company's capital in those companies, but I thought it made good sense to share those opportunities with HealthSouth. Sometimes HealthSouth thought it was in the Company's and its shareholders' best interests to invest and did so. And more times than not, HealthSouth declined to make an investment. There is not one example of a time when I or my firm pressured HealthSouth to make an investment. In virtually all of those transactions, HealthSouth and its shareholders have benefited.

HealthSouth, despite the enormity of the malfeasance committed by a few individuals, has clearly contributed a great deal to the healthcare industry. The fact that the Company is still standing strong and has staved off bankruptcy is a testament to its employees and the quality of medical care it has provided to millions of patients. Indeed, I believe that with the dedication and leadership of the Board and the new management team, HealthSouth will continue to make an enormous contribution to medical care in this country. My focus as a Board member has always been, and continues to be, to ensure HealthSouth's future as a viable, strong and ethical business.

I support this Committee's efforts to identify the facts and to seek ways of preventing this type of fraud in the future. Thank you.

Mr. GREENWOOD. Well, thank you, Ms. Givens.

Dr. Watkins, do you have an opening statement, sir?

#### **TESTIMONY OF PHILLIP WATKINS**

Mr. WATKINS. Good morning, Mr. Chairman, ranking member, and members of the subcommittee.

My name is Dr. Phillip Watkins. I am a former member of the HealthSouth Board of Directors. I resigned from the Board in February 2003 and am proud of my long service on behalf of HealthSouth and its stockholders. And I welcome the opportunity to share with the subcommittee my insight into the Board's functions.

Let me describe my background. I am a cardiologist in private practice in Birmingham where I grew up. Went to undergraduate and medical school, trained at the Mayo Clinic in and specialized in cardiovascular disease.

I first became involved with HealthSouth, which was a startup brand new company then known as Amcare, in 1983, after I first met Richard Scrushy. Mr. Scrushy proposed a merger of my practice's cardiac rehabilitation facility with Amcare to form what is known at that time as a "CORF" or a comprehensive outpatient rehabilitation facility.

In 1984, I was asked by Mr. Scrushy to join the company's Board of Directors, 2 years before HealthSouth became a publicly traded company. As a physician and director, it was determined that I could add valuable insight by talking to our physicians and helping to meet their needs in working at and with our facilities. Our ability to provide high quality, efficient, low cost patient care was the core of the company's business.

Early on, I was appointed Chairman of the Board's audit & compensation committee. At that time the company was a startup with such a small Board that these two functions were combined to form one committee. At that time, many companies followed that practice. Later, the committees were separated into two distinct committees.

As Chairman of the audit & compensation committee, I worked with and relied upon the outside experts hired by our Board. For example, we hired Mercer Human Resource Consulting to assist our committee on compensation questions and act as our compensation consultants. Mercer retains a reputation as one of the largest and most relied upon compensation consulting firms in the country. Mercer analyzed the compensation trends of similar firms in the healthcare industry and, along with other experts we employed, advised the compensation committee on our compensation plans. It was based upon this information and advice that we determined the compensation packages of HealthSouth's management team.

By all accounts, HealthSouth was growing at an exciting pace, and was singled out by publications such as "Forbes" and "Fortune," as an up and coming star in the field of outpatient surgery and rehabilitation. Since I joined the HealthSouth Board in 1984, I have seen HealthSouth grow from a company with two rehabilitation facilities, one in Little Rock and one in Birmingham, to become the largest outpatient surgery, rehabilitation and diagnostic services company in the world with over 48,000 employees.

The compensation for HealthSouth senior executives, including Mr. Scrushy, was based upon this apparent outstanding performance, and the committee was always assured by the independent analyses of experts such as Mercer that the Board's compensation philosophy was entirely in keeping with the best practices at the time. Specifically, we implemented a performance based incentive-compensation program, which included annual bonuses, stock option grants under a stockholder approved option plan. We now know the numbers we relied on and were certified by our outside accountants to calculate these numbers were fraudulent. If the compensation committee had known of the fraud, Mr. Scrushy and others had done, we would have been terminated him immediately and they would never have received any of their salaries, bonuses or and stock options.

I was as shocked and angry as the rest of the public when I learned that senior members of HealthSouth's management team had been perpetrating a fraud on HealthSouth's stockholders. As the indictment stated, the Board of Directors was similarly deceived by fraud. These criminal conspirators were able to fraudulently conceal or otherwise alter information and documents that all of the experts including the accounting firm of Ernst & Young could not detect the fraud. As a corporate director, I relied upon the accuracy of information provided to me by both management and by outside experts such as Ernst & Young. It is now evident that because the truth had been so thoroughly concealed by certain former members of management, the probing questions and activism of this Board could not have discovered the existence of this accounting fraud.

Let me conclude by saying that I am proud of my service to the HealthSouth Board. HealthSouth enabled me to combine my obligation as a medical doctor to patients along with that as a director to the company to its stockholders. Had I known of the hidden fraud being perpetrated on us all, I would have acted quickly and decisively, just as the current Board has done in removing those responsible.

HealthSouth is one of the great healthcare companies in America and I am confident that it will continue to go forward under the guidance of the new management team.

I look forward to answering any questions.

[The prepared statement of Phillip Watkins follows:]

PREPARED STATEMENT OF PHILLIP WATKINS

Mr. Chairman, Ranking Member, and members of the Subcommittee, good morning.

My name is Dr. Phillip Watkins, and I am a former member of the HealthSouth Board of Directors. I resigned from the Board in February 2003 and am proud of my long service on behalf of HealthSouth and its stockholders. I welcome the opportunity to share with the Subcommittee my insight into the Board's functions at HealthSouth.

First, let me describe my background. I am a cardiologist in private practice in Birmingham where I grew up. I attended the University of Alabama, the Medical College of Alabama, trained at the Mayo Clinic in Internal Medicine and specialized in Cardiovascular Disease. I am currently the Medical Director of The Autonomic Disorders and Mitral Valve Prolapse Center located in Birmingham, Alabama.

I became involved with HealthSouth, a brand new company then known as Amcare, in 1983, after I first met Mr. Scrusby. Mr. Scrusby proposed a merger of my practice's cardiac rehabilitation facility with Amcare to form what is known as a "CORF"—Comprehensive Outpatient Rehabilitation Facility. The unique concept of a CORF was to combine outpatient surgery and rehabilitation facilities into one stand-alone medical complex in order to ease patient burden and expense, and ultimately provide for more successful patient recoveries.

In 1984, I was asked by Mr. Scrusby to join the Company's Board of Directors, two years before HealthSouth became a publicly traded company in 1986. As a physician and director, it was determined that I could add valuable insight by talking to physicians and helping to meet their needs in working with our facilities. Our ability to provide high quality, efficient, low cost patient care was the core of the Company's business.

Early on, I was appointed Chairman of the Board's Audit & Compensation Committee. At that time the Company was a startup with such a small board that these two functions were combined to form one committee. At that time, many companies followed this practice. Later, the committees were separated into two distinct committees.

As Chairman of the Audit & Compensation Committee, I worked with and relied upon the outside experts hired by our Board. For example, we hired Mercer Human Resource Consulting to assist the Committee as our compensation consultants. Mercer retains a reputation as one of the largest and most relied upon compensation consulting firms in the country. Mercer analyzed the compensation trends of similar firms in the healthcare industry and, along with other experts, advised the Compensation Committee. It was based upon this information and advice that we determined the compensation packages of HealthSouth's management team.

By all accounts, HealthSouth was growing at an exciting pace, and was singled out by numerous industry publications, including Forbes and Fortune, as an up and coming star in the field of outpatient surgery and rehabilitation. Since I joined the HealthSouth Board in 1984, I have seen HealthSouth grow from a company with two rehabilitation facilities—one in Little Rock and one in Birmingham—to become the largest outpatient surgery company, rehabilitation company and diagnostic services company in the world with over 48,000 employees throughout the country. The compensation for HealthSouth senior executives, including Mr. Scrusby, was based upon this apparent outstanding performance, and the Committee was always assured by the independent analyses of experts such as Mercer that the Board's compensation philosophy was entirely in keeping with the best practices at the time. Specifically, we implemented a performance based incentive-compensation program,

which included annual bonuses and stock option grants under a stockholder-approved option plan.

We now know the numbers we relied on and were certified by our outside accountants to calculate senior management compensation were fraudulent. If the Compensation Committee had known of the fraud, Mr. Scrushy and others would have been terminated immediately and would never have received these salaries, bonuses, and stock options.

I was as shocked and angry as the rest of the public when I learned that senior members of HealthSouth's management team had been perpetrating a fraud on HealthSouth's stockholders. The Board of Directors was similarly deceived. These criminal conspirators were able to fraudulently conceal or otherwise alter information and documents such that all of the experts including the accounting firm of Ernst & Young did not detect the fraud. As a corporate director, I relied on the accuracy of information provided to me by management and by outside experts such as Ernst & Young. It is now evident that because the truth had been so thoroughly concealed by certain former members of management, the probing questions and activism of this Board could not have discovered the existence of this accounting fraud.

In addition to questioning former management and outside experts, the Company had in place internal control systems designed, in part, to catch fraud. But every system of checks and balances is only as good as the people who are there and use them. Ms. Henze testified that she did use the compliance system we had set up to receive and act upon such information. That's how the compliance system was supposed to work. It is incomprehensible to me how designated compliance personnel could have received such apparently clear information and could not have told Ernst & Young, the Audit Committee or the Board.

Just to be clear, the fraud occurred at a corporate level. Ernst & Young conducted the corporate-wide audit. In contrast, internal audit conducted facility level audits. The Subcommittee heard testimony two weeks ago from Ms. Teresa Sanders and Mr. Greg Smith of HealthSouth's internal audit department. The Audit Committee did meet on a regular basis with Ms. Sanders and Mr. Smith and received their reports and questioned both of them. In fact, I had more internal auditors added to the internal audit staff after talking to Ms. Sanders. They never told us they had any suspicion of impropriety.

Let me conclude by saying that I am proud of my service to the HealthSouth Board. HealthSouth enabled me to combine my obligation as a medical doctor to patients with that as a director of the Company to the stockholders. Had I known of the hidden fraud being perpetrated on us all, I would have acted quickly and decisively, just as the current Board has in removing those responsible. HealthSouth is one of the great healthcare companies in America and I am confident that it will continue to be under the guidance of the new management team. I look forward to answering any questions you or any other members of the Subcommittee may have.

Mr. GREENWOOD. Thank you, Dr. Watkins.

Mr. Striplin, do you have an opening statement, sir?

#### **TESTIMONY OF LARRY D. STRIPLIN**

Mr. STRIPLIN. Mr. Chairman, ranking member, and members of the subcommittee, good morning.

Mr. GREENWOOD. You need to turn on your microphone and maybe point it toward you a little bit. Turn it down a little bit so it's pointing toward you. There you go.

Mr. STRIPLIN. Mr. Chairman and ranking member, and members of the subcommittee, good morning.

My name is Larry Striplin, and I am a member of the HealthSouth Board of Directors. And I joined the Board in April 1999, and have been proud to serve with the talented and experienced directors seated next to me today.

As you know, HealthSouth grew from a company with two patient care facilities, one in Little Rock and one in Birmingham, to a company with more than 1,700 facilities across the country. HealthSouth has set the standard for providing state-of-the-art rehabilitation services to patients ranging from professional athletes

recovering from sports injuries to grandparents recovering from strokes.

First, let me tell you a little of my background. I am a native of Selma, Alabama. I graduated from Birmingham-Southern College with a degree in education. I pursued my education at George Peabody College (now a part of Vanderbilt University) in Nashville, Tennessee, where I obtained a master's degree in Education.

I have owned and operated my own business, Nelson Brantley Glass Company, since 1963 and am currently the Chairman and CEO of this company. I also serve as CEO of Circle "S" Industries. Also, in 1977, I established American Fine Wire, which was one of Selma's largest employers. I am a member of the Boards of directors of Kulicke & Suffa Industries, Inc., which purchased American Fine Wire.

In addition to my work with my own companies, I have always been actively involved in various civic activities. I was instrumental in establishing the Alabama Sports Hall of Fame and have served on its Board of Directors for 23 years, 13 of those as Chairman.

I also founded and serve as Chairman of the Bryant Jordon Student Athletic Foundation, which provides scholarships to student athletes.

And have served as Chairman of the Birmingham Park and Recreation Board, a member of the Birmingham Business Leadership Council, and a board member of the Alabama Sports Foundation and the American Sports Medicine Institute.

I am currently a trustee of Birmingham-Southern College and its executive committee. And I also serve on the board of the University of South Alabama.

In part, it was HealthSouth's work in the field of sports rehabilitation that drew me to the company. I was proud to help direct a company that had such a positive impact on the health and fitness of people of all walks of life.

When the allegations of fraud came to light in March 2003, I was as shocked and dismayed as my fellow directors. Nonetheless, the Board quickly took steps to stem the crisis and stabilize the business. As you know, Mr. Scrusby was put on an immediate leave of absence, and we appointed Joel Gordon as interim Chairman and Bob May as interim chief executive. Additionally, we brought in a first-rate experienced outside advisors headed by Bryan Marsal, our chief restructuring officer, to assist us in getting control of the situation. These three people, with the help of many others, have done an outstanding job. And our first priority, of course, was to ensure that HealthSouth was able to continue to provide the much needed healthcare services to all of its patients.

I am pleased to report that HealthSouth has made tremendous progress over the past 7 months under the leadership of these interim management team. Our employees have also played a very large role in the company's recovery, and I would like to take this opportunity to thank them. They have remained focused on the task at hand and they have continued to deliver high quality care to thousands of patients every day.

Mr. Chairman I will, to the best of my ability, be glad to answer any questions you or other members of the subcommittee may have.

[The prepared statement of Larry D. Striplin follows:]

PREPARED STATEMENT OF LARRY D. STRIPLIN

Mr. Chairman, Ranking Member, and members of the Subcommittee, good morning.

My name is Larry Striplin, and I am a member of the HealthSouth Board of Directors. I joined the Board in April 1999, and have been proud to serve with the talented and experienced directors seated next to me today. As you know, HealthSouth grew from a company with two patient care facilities—one in Little Rock, Arkansas, and one in Birmingham, Alabama—to a company with more than 1,700 facilities across the country. HealthSouth has set the standard for providing state of the art rehabilitation services to patients ranging from professional athletes recovering from sports injuries to grandparents recovering from strokes.

First, let me tell you about my background. I am a native of Selma, Alabama. I graduated from Birmingham-Southern College with a degree in education. I pursued my education at George Peabody College (now Vanderbilt University) in Nashville, Tennessee, where I obtained a masters degree in Education.

I have owned and operated my own business, Nelson Brantley Glass Contractors, since 1963 and am currently CEO of this company. I also serve as CEO of Circle "S" Industries. Also, in 1977, I established American Fine Wire, which was one of Selma, Alabama's largest employers. I am a member of the boards of directors of Kulicke & Suffa Industries, Inc., which purchased American Fine Wire.

In addition to my work with my own companies, I have always been actively involved in various civic activities. I was instrumental in establishing the Alabama Sports Hall of Fame and have served on its board of directors for twenty-three years, thirteen of those as Chairman. I also founded and serve as Chairman of the Bryant Jordon Student Athletic Foundation, which provides scholarships to student athletes. I have served as Chairman of the Birmingham Park and Recreation Board, a member of the Birmingham Business Leadership Council, and a board member of the Alabama Sports Foundation and the American Sports Medicine Institute. I am currently a Trustee of Birmingham-Southern College and its Executive Committee. I also serve on the board of the University of South Alabama.

In part, it was HealthSouth's work in the field of sports rehabilitation that drew me to the Company. I was proud to help direct a company that had such a positive impact on the health and fitness of people from all walks of life.

When the allegations of fraud came to light in March 2003, I was as shocked and dismayed as my fellow directors. Nonetheless, the Board quickly took steps to stem the crisis and stabilize the business. As you know, Mr. Scrusby was put on an immediate leave of absence, and we appointed Joel Gordon as Interim Chairman and Bob May as Interim Chief Executive Officer. Additionally, we brought in a first-rate team of experienced outside advisors—including Bryan Marsal, our Chief Restructuring Officer—to assist us in getting control of the situation. These three people—with the help of many others—have done an outstanding job. Our first priority, of course, was to ensure that HealthSouth was able to continue to provide the much needed healthcare services to all of its patients.

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Mr. Chairman I will, to the best of my ability, be glad to answer any questions you or other members of the Subcommittee may have.

Mr. GREENWOOD. Thank you, Mr. Striplin.  
Mr. May?

**TESTIMONY OF ROBERT MAY**

Mr. MAY. Mr. Chairman, ranking member, and members of the subcommittee, good morning.

My name is Robert May, and I am the interim chief executive officer of HealthSouth, and a member of the HealthSouth Board of

Directors. I appreciate the opportunity to appear before the subcommittee today and look forward to answering your questions. I also look forward to describing for you the deliberate and purposeful steps taken by our Board of Directors, our management team, and our employees since we, along with the rest of the public, first became aware of the allegations of accounting fraud at the company.

I joined the company's Board of Directors at the end of September 2002 along with my fellow Board member, Jon Hanson, as independent directors. Among our other duties, we looked forward to helping the company to conform its governance platform to the requirements of the newly enacted Sarbanes-Oxley Act and the proposed listing standards of the New York Stock Exchange.

From 1973 to 1993, I held a variety of executive and operational positions at Federal Express Corporation, most recently as President of Business Logistics.

Following my tenure with FED EX, I became chief operating officer and a director of Cablevision Systems Corp., where I was part of the executive team that helped transition the company through new operating strategies and the use of new technologies.

Since the allegations of accounting fraud were first disclosed last March, the Board acted quickly and decisively to ensure that Mr. Scrushy and those members of management alleged to have assisted him in perpetrating a fraud on HealthSouth stockholders were immediately terminated.

For the past 7 months, I have been serving as the interim CEO, helping to lead the company's day-to-day operations. As a part of the interim management team, I have worked to help stabilize the company's financial situation and refocus our core operations on patient care.

As you have heard from previous testimony, some employees at HealthSouth felt afraid and intimidated, feelings no employee should have in the workplace. We have sought to transform the culture of HealthSouth, especially at the corporate headquarters. On a symbolic level, we have taken down Mr. Scrushy's name from our corporate conference center; opened up the formerly restricted executive floors to all employees; and closed the executive dining room so that our leadership team eats in our cafeteria with the company's employees.

I also hold regular, open, informal brown bag lunch meetings with employees from all levels and departments of the Company; encouraging them to ask questions or raise issues and sharing information about our plans and goals for the company. While this is not an unusual practice in corporate America, it began at HealthSouth only when the interim management team took charge. The response has been encouraging at all levels of the company. We also hold regular broadcasts to reach our 48,000 employees in the field, and we have traveled extensively to many of our field locations throughout the country.

We have also looked closely at our governance policy and compliance programs. I chair the corporate governance committee. My fellow committee members and I have recently updated our governance and compliance systems, a process that began when I joined the Board. Further changes are about to be incorporated as a result

of adopting recent changes suggested by the New York Stock Exchange.

Assisting in our effort is a team of outside expert advisors, including the noted Professor Charles M. Ellson, the Director of the Center for Corporate Governance at the University of Delaware.

With the aid of this governance advisory panel, my fellow directors and I drafted corporate governance policies for our Board committees that meet or exceed the requirements of Sarbanes-Oxley and the New York Stock Exchange with respect to important issues such as director independence. These new guidelines take into account not only legal and regulatory requirements, but also current corporate governance best practices.

HealthSouth's governance committee, again with the input from our governance advisory panel, began to search for additional corporate directors who could bring valuable new experience and abilities to the Board. We have retained two nationally recognized search firms and have interviewed numerous candidates. Despite a lapse in our directors and officers insurance, we have attracted a talented, courageous new Board member, Lee Hillman, who now serves as Chairman of the audit committee.

I know this Committee is interested in the internal investigation conducted by the outside law firm of Fulbright & Jaworski into the issue of insider trading and management's knowledge, specifically that of Richard Scrushy, of the impact on company earnings of a new Medicare billing rule known as CMS Transmittal 1753.

The Board retained Fulbright & Jaworski on September 17, 2002, prior to my Board appointment, and granted Fulbright & Jaworski total access to all corporate records and mandated that all management and employees cooperate fully in this internal investigation. The Board received regular updates, and ultimately, on October 21, 2002, received a report which indicated that, based on Fulbright's review, they could find no evidence that Mr. Scrushy had known of the impact of Transmittal 1753 at the time of certain stock sales executed by him. The Board was never given a reason to believe that the Fulbright & Jaworski investigation was anything other than a thorough and adequate investigation into insider trading allegations. I and other directors certainly understood from the briefings conducted by Fulbright & Jaworski that they had found no evidence of inappropriate or illegal conduct by Mr. Scrushy connected with his sale of stock. We continue to cooperate with all government authorities as they look into this and other areas.

My focus now is on stabilizing the company's financial position in order to ensure a viable future. We have made progress, and I am pleased to say that we are strengthening relationships with our payors, vendors, doctors and other outside parties critical to the continued success of HealthSouth.

We are also developing new sources of revenue in our core areas, as demonstrated by new and expanded contracts with payors. As interim CEO, I have promised our 48,000 employees that we are committed to a future where the company's goal of providing excellent patient care comes first.

We believe the fundamentals are in place at numerous levels of HealthSouth for renewed success, but we will continue to improve

the corporate culture to ensure that appropriate principles are effectively put into practice. Continuing to examine and enhance policies to prevent corporate fraud is important. However, in my opinion, the most critical element in prevention is providing a culture where employees are able to ask questions, challenge decisions and communicate with management in an open and direct fashion. It was a group of individuals who committed the fraud and engaged and criminal activities at HealthSouth, and without an employee stepping forward in this case, we still might not know the depths of the fraud that was perpetrated against the company and its stakeholders.

Let me end by saying that the Board and the management team are committed to taking the necessary actions to ensure that we reach the goal of restoring the long-term health and viability of HealthSouth, and we are committed to assisting this subcommittee in its work.

Mr. Chairman, I appreciate this opportunity and will, to the best of my ability, be glad to answer questions you or any other members of the subcommittee may have.

[The prepared statement of Robert May follows:]

PREPARED STATEMENT OF ROBERT MAY

Mr. Chairman, Ranking Member, and members of the Subcommittee, good morning.

My name is Robert May, and I am the Interim Chief Executive Officer of HealthSouth, and a member of the HealthSouth Board of Directors. I appreciate the opportunity to appear before the Subcommittee today and look forward to answering your questions. I also look forward to describing for you the deliberate and purposeful steps taken by our Board of Directors, our management team, and our employees since we, along with the rest of the public, first became aware of the allegations of accounting fraud at the Company.

I joined the Company's Board of Directors at the end of September 2002 along with my fellow Board member, Jon Hanson. Among our other duties, we looked forward to helping the Company to conform its governance platform to the requirements of the newly enacted Sarbanes-Oxley Act and the proposed listing standards of the New York Stock Exchange.

From 1973 to 1993, I held a variety of executive and operational positions at Federal Express Corporation, most recently as President of Business Logistics. Following my tenure with FED EX, I became chief operating officer and a director of Cablevision Systems Corp., where I was part of the executive team that helped transition the Company through new operating strategies and the use of new technologies.

Since the allegations of accounting fraud were first disclosed last March, the Board acted quickly and decisively to ensure that Mr. Scrusby and those members of management alleged to have assisted him in perpetrating a fraud on HealthSouth stockholders were immediately terminated.

Since late March 2003, I have been serving as the Interim CEO, helping to lead the Company's day-to-day operations. As part of the interim management team, I have worked to help stabilize the Company's financial situation and refocus our core operations on patient care.

As you have heard from previous testimony, some employees at HealthSouth felt afraid and intimidated, which should have no place in any workplace. We have sought to transform the culture of HealthSouth, especially at the corporate headquarters. On a symbolic level, we have taken down Mr. Scrusby's name from our corporate conference center; opened up the formerly restricted executive floors to all employees; and closed the executive dining room so that our leadership team eats in our cafeteria with the Company's employees.

I also hold regular, open, informal brown bag lunch meetings with employees from all levels and departments of the Company—encouraging them to ask questions or raise issues—and sharing information about our plans and goals for the Company. While this is not an unusual practice in corporate America, it began at HealthSouth only when the interim management team took charge. The response has been en-

couraging at all levels of the Company. We also hold regular broadcasts to reach our 48,000 employees in the field, and we have traveled to many of our field locations throughout the country.

We have also looked closely at our governance policies and compliance programs. I chair the Corporate Governance Committee. My fellow committee members and I have recently updated our governance and compliance systems, a process that began when I joined the Board. Further changes are about to be incorporated as a result of adopting recent changes suggested by the New York Stock Exchange. Assisting in our effort is a team of outside expert advisors, including the noted Professor Charles M. Ellson, the Director of the Center for Corporate Governance at the University of Delaware. With the aid of this governance advisory panel, my fellow directors and I drafted corporate governance policies for our Board committees that meet or exceed the requirements of Sarbanes-Oxley and New York Stock Exchange with respect to important issues such as director independence. These new guidelines take into account not only legal and regulatory requirements, but also current corporate governance best practices.

HealthSouth's Governance Committee, again with the input from our governance advisory panel, began to search for additional corporate directors who could bring valuable new experience and abilities to the Board. We have retained two nationally recognized search firms and have interviewed numerous candidates. Despite a lapse in our Directors and Officers insurance, we have attracted a talented, courageous new Board member, Lee Hillman, who now serves as Chairman of our Audit Committee.

We have also drafted and approved charters for Board committees and reengineered our compliance programs. As part of those revised compliance procedures, the Corporate Compliance Officer now reports independently to the Compliance Committee. In that same vein, the internal auditor reports independently to the Audit Committee.

I know this Committee is also interested in the internal investigation conducted by the outside law firm of Fulbright & Jaworski into the issue of insider trading and management's knowledge, specifically that of Richard Scrusby, of the impact on Company earnings of a new Medicare billing rule known as CMS Transmittal 1753. The Board retained Fulbright & Jaworski on September 17, 2002, prior to my Board appointment, and granted Fulbright & Jaworski total access to all corporate records and mandated that all management and employees cooperate fully in this internal investigation. The Board received regular updates, and ultimately, on October 21, 2002, received a report which indicated that, based on Fulbright's review, they could find no evidence that Mr. Scrusby had known of the impact of Transmittal 1753 at the time of certain stock sales executed by him. The Board was never given a reason to believe that the Fulbright & Jaworski investigation was anything other than a thorough and adequate investigation into insider trading allegations. I and other directors certainly understood from the briefings conducted by Fulbright & Jaworski that they had found no evidence of inappropriate or illegal conduct by Mr. Scrusby connected with his sale of stock. We continue to cooperate with all government authorities as they look into this and other areas.

My focus now is on stabilizing the Company's financial position in order to ensure a viable future. We have made progress, and I am pleased to say that we are strengthening relationships with our payors, vendors, doctors and other outside parties critical to the continued success of HealthSouth. We are also developing new sources of revenue in our core areas, as demonstrated by new and expanded contracts with payors. As interim CEO, I have promised our 48,000 employees that we are committed to a future where the Company's goal of providing excellent patient care continues to come first.

We believe the fundamentals are in place at numerous levels of HealthSouth for renewed success, but we will continue to improve the corporate culture to ensure that appropriate principles are effectively put into practice. Continuing to examine and enhance policies to prevent corporate fraud is important. However, in my opinion, the most critical element in prevention is providing a culture where employees are able to ask questions, challenge decisions and communicate with management in an open and direct fashion. It was a group of individuals who committed the fraud and engaged in criminal activities at HealthSouth—and without an employee stepping forward in this case, we still might not know the depths of a fraud that was perpetrated against the Company and its stakeholders.

Let me end by saying that the Board and management team are committed to taking the necessary actions to ensure that we reach the goal of restoring the long-term health and viability of HealthSouth, and we are committed to assisting this Subcommittee in its work.

Mr. Chairman, I appreciate this opportunity and will, to the best of my ability, be glad to answer questions you or any other members of the Subcommittee may have.

Mr. GREENWOOD. The Chair recognizes himself for 10 minutes.

And, Mr. Gordon, I would like to pose some questions to you, if I might.

If you would turn to Tab 6 in your binder. Okay. See that document there? And there are handwritten notes. Those handwritten notes, is that in your writing?

Mr. GORDON. Yes it is.

Mr. GREENWOOD. Okay. And identify what the document is, please.

Mr. GORDON. It's the Board minutes of August 7, 2002.

Mr. GREENWOOD. Okay. Turn to page 3 of that document. Is that your handwriting there?

Mr. GORDON. Yes, it is.

Mr. GREENWOOD. Okay. Can you say what that says? Read what that says, next to where "The Chairman's review."

Mr. GORDON. Okay. What it says, we were discussing a presentation made by the bankers in regard to spinoff for other things. And I commented that I thought the presentation was very poorly devised and not achievable.

Mr. GREENWOOD. Now, did you comment that that reflects what you said outside or does that reflect your thoughts at the time?

Mr. GORDON. No, that reflects my thoughts when the minutes came in, and I put this on and sent it back to the secretary—for his consideration to be included in the minutes.

Mr. GREENWOOD. Okay. And when did you get these minutes?

Mr. GORDON. I cannot give you the exact dates. Basically we had—minutes came very slowly. I have in my records where I had a waiver of notice of 13 minutes that came—that covered the period from February—probably from November 2002 through March 2003 that I received in probably February to sign a waiver of notice of minutes, and I never signed that and returned it.

Mr. GREENWOOD. Okay. When you wrote "presentation was poorly designed and not achievable," what were you referring to who made this presentation to the Board?

Mr. GORDON. Well, this was a presentation made by Mr. McGahan, and I guess the presentation was that the surgery center division was worth eleven times—and from my experience in the industry, I just did not think that was an achievable number. I thought something more like seven times would be something would be a market that would be received.

Mr. GREENWOOD. All right. And did you say at that time, at the time of the presentation?

Mr. GORDON. I said that at the time of the meeting. The time of the Board meeting.

Mr. GREENWOOD. Was Mr. Scrusby there at that time?

Mr. GORDON. Yes.

Mr. GREENWOOD. And how did he react? Did he react to your comment?

Mr. GORDON. He reacted that the bankers had thought they had sources that would pay that much to buy the surgery center operation.

Mr. GREENWOOD. Is that the same meeting where Mr. Scrushy told the Board that there was a Medicare transmittal regarding out patient group therapy?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. What did Mr. Scrushy say about the impact of the transmittal at the time?

Mr. GORDON. I think that presentation was made by Mr. Owens, and he said that it would effect the company somewhere between \$15 and \$20 million.

Mr. GREENWOOD. He thought that would be the impact of the Medicare, the transmittal?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. Did you have concerns about the fact that a few days earlier Mr. Scrushy had announced excellent earnings for the company?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. Can you explain those concerns?

Mr. GORDON. Well, I was concerned that we had reported on August 6 that our earnings were within line and we expected to achieve the goal for 2002, and then we came out on August 8 and said we had this problem and that we would not make those earnings. And I was concerned about dissemination of information. I did not know if that was accurate.

Mr. GREENWOOD. Okay. And turn to Tab 7 on page 3, if you would. Do you see that?

Mr. GORDON. See what?

Mr. GREENWOOD. These are Board minutes from the August 26, 2002 meeting.

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. Do you recall attending that meeting?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. And during that meeting did Mr. Scrushy ask the Board to ratify a spinoff of the surgery division?

Mr. GORDON. That was—yes.

Mr. GREENWOOD. And did you agree with—

Mr. GORDON. A spinoff or a sale. At that time, I guess it was a spinoff.

Mr. GREENWOOD. I beg your pardon?

Mr. GORDON. I did agree at that time, yes, at the right price if we could do it.

Mr. GREENWOOD. Okay. So you agreed with the proposal?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. Did you vote for the spinoff?

Mr. GORDON. I believe I did not vote against it. I think I just choose to abstain.

Mr. GREENWOOD. You abstained?

Mr. GORDON. Yes.

Mr. GREENWOOD. And why did you abstain?

Mr. GORDON. I was not exactly confident that this was the right thing to do for the company or for the stakeholders.

Mr. GREENWOOD. Did you not just say you thought it was a good idea at the time?

Mr. GORDON. Well, I think basically if we could accomplish it eleven times, it was. I did not feel confident we could do that.

Mr. GREENWOOD. And did you say that?

Mr. GORDON. Yes.

Mr. GREENWOOD. So you said I do not think we are going to be able to make the profit out of this that you have presented here. Was there discussion about that?

Mr. GORDON. I do not think I did not say there would not be a profit. I said we could not achieve—

Mr. GREENWOOD. The level?

Mr. GORDON. [continuing] the level of sale price that we expected.

Mr. GREENWOOD. Okay. All right.

And was there discussion? I mean, was this not the division that you brought in, was this not—

Mr. GORDON. I think there was discussion, but it was very confidently expressed that this was achievable.

Mr. GREENWOOD. Okay. And so you abstained?

Mr. GORDON. Yes.

Mr. GREENWOOD. Now, is it accurately reflected in the minutes that “no votes were cast against the motion?”

Mr. GORDON. I do not recall that, and I do recall not being in favor of it. But I do not know if it’s—you know, it is—if I recall I abstained.

Mr. GREENWOOD. Okay.

Mr. GORDON. Now I did not vote against it.

Mr. GREENWOOD. Okay. So then the minutes would reflect that there were no votes cast against it?

Mr. GORDON. That is right, I did not vote against it.

Mr. GREENWOOD. Just your abstention?

Is that the way you would have wanted the minutes to reflect your opposition?

Mr. GORDON. When I—again, I would not have wanted them to be that way, but that is the way they turned out. And I think later I did suggest if that was accurate, and I was told they were accurate. And that was the way we reflected.

Mr. GREENWOOD. What was your reaction to Mr. Scrusky announcement of the \$175 million impact on the company?

Mr. GORDON. To me it was shock. I was just shocked to how it could have been one number so—in early August and be such—

Mr. GREENWOOD. \$15 or \$20 million you were told initially?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. And then Mr. Scrusky said actually it is \$175 million, not \$15 or \$20 million?

Mr. GORDON. I think Mr. Owens probably made that—made that report.

Mr. GREENWOOD. Were you suspicious?

Mr. GORDON. I wondered why such a large change in such a short amount of time, why it was.

Mr. GREENWOOD. Did you wonder that out loud?

Mr. GORDON. I do not recall saying that out loud at that time.

Mr. GREENWOOD. Why would you not? I mean, you are a member of the Board of Directors, you are sitting there, you are shocked. You said you are shocked, you are amazed that a number that was originally presented at \$15 to \$20 million had—

Mr. GORDON. I requested—

Mr. GREENWOOD. [continuing] quickly grown to \$175 million. You are an important member of the Board of Directors you are shocked, you yet kept silent?

Mr. GORDON. I requested further information where I could search for myself what the consequence was. At the time I was not totally familiar with 1753. I wanted to read that and see what the consequences. I thought—

Mr. GREENWOOD. At that Board meeting at that moment you said I would like some more information on this, or was that—

Mr. GORDON. I think privately I told some officers that I would like to have a copy of it 1753 and see if could see—

Mr. GREENWOOD. Okay. Would you turn to Tab 8, please.

Mr. GORDON. Sir?

Mr. GREENWOOD. Tab 8 in your book. Do you see that document there?

Mr. GORDON. Yes. Yes.

Mr. GREENWOOD. Would you identify that document?

Mr. GORDON. This is a letter on August 30 that I wrote to Richard Scrushy.

Mr. GREENWOOD. Okay. And why did you write this letter?

Mr. GORDON. Why? I was concerned that I did not have enough information about what was taking place in regard to this spinoff or sale of the facilities, what was taking place generally in regard to the future of the company and I was writing for more information for my consideration.

Mr. GREENWOOD. You said in this letter, you said “Based on the information provided by UBS Warburg, I remain unconvinced that this is the best route to maximize shareholder value, as you no doubt surmised from my comments during the Board meeting and my abstention vote with regard to this matter on the August 26, 2002 Board of Directors meeting.

Mr. GORDON. Right.

Mr. GREENWOOD. So you were unconvinced on August 30.

Did Mr. Scrushy ever respond to this letter and, in fact, give you the information that you wanted?

Mr. GORDON. No.

Mr. GREENWOOD. Did you continue to register opposition to the spinoff?

Mr. GORDON. I continued to—yes. I continued to write him about further information that I required, and I never received anything I asked for.

Mr. GREENWOOD. Were any other Board members aware of your concerns? Did you share your concerns with other Board members?

Mr. GORDON. I do not believe I did at this time. I did in a later correspondence.

Mr. GREENWOOD. Okay. What did you make of the fact that you wrote this? You had enough concern to write this letter and you never got a response to it?

Mr. GORDON. Well, starting about this time, Mr. Scrushy and I had many differences. We have had differences from day one that I had been on the Board. Those differences got more and more evident as time went on.

Mr. GREENWOOD. In the indictment that was issued yesterday, there was talk of intimidation used by Mr. Scrushy. As you and

Mr. Scrusby had this apparent falling out and you had lots of difference of opinions, can you characterize the way he treated you? Was he abusive toward you?

Mr. GORDON. Well, he never intimidated me, because I am the type of fellow that someone such as him would not intimidate.

And many times he dressed me down that I was not one to grow the company, I did not hear what he had to say; when I asked questions, I got that thing. But it never intimidated me.

Mr. GREENWOOD. Did he do that in front of others?

Mr. GORDON. Yes.

Mr. GREENWOOD. Okay. Did Mr. Scrusby ever say to you that he wanted to remove certain members from the Board?

Mr. GORDON. Yes.

Mr. GREENWOOD. And who were those Board members and what were the circumstances?

Mr. GORDON. Well, I had a private meeting with him in February 2003. And—

Mr. GREENWOOD. How did that come to be? Why was that? Was that at your request or his?

Mr. GORDON. I had been corresponding him with on a regular basis and he could tell that my correspondence was, I guess, getting more and more concerned. And he called and asked me would I come down and visit him. At the time, I said I will wait until the next Board meeting. And then he called back, his secretary called and said he would sure like to visit with you. And I asked, I said well I will try to work it into my schedule.

And so I went down and visited with him.

Mr. GREENWOOD. Where was this meeting?

Mr. GORDON. In Birmingham at the corporate office.

Mr. GREENWOOD. At the corporate office. Okay.

Mr. GORDON. And at the time he proposed to me that there may be some people did not want me on the Board, but he would like to have me on the Board under one condition, and if I would vote against Bob May, he would support me. My response was "Richard, I do not play games like that."

Mr. GREENWOOD. Okay.

Mr. GORDON. And I did not have any—

Mr. GREENWOOD. My time has expired.

A final question for me. As we now know from the criminal indictment, this \$175 million impact was a sham designed by Scrusby to hide the fraud. Did you have any suspicions about that? During the fall of 2002 did you think it was more than just an overly optimistic expectation, or rather, excuse me. Did you think it was more than just bad corporate news, but in fact might have been a scheme or a sham to hide other dealings?

Mr. GORDON. I did not have—at that time, I did not have any idea that it was a sham. You know, as the things turned out, I see that it probably was. But at that time I had no thought of that.

Mr. GREENWOOD. The gentlelady from Colorado is recognized for 10 minutes.

Ms. DEGETTE. Thank you, Mr. Chairman.

Mr. Gordon, did you ever see Mr. Scrusby attempt to intimidate others the way you just described to the Chairman he was trying to intimidate you?

Mr. GORDON. I do not think I did, no.

Ms. DEGETTE. Now, when the allegations of insider trading and other allegations of misconduct came to your attention in the summer of 2002, you decided that an independent counsel should be hired by the compliance committee, right?

Mr. GORDON. As Chairman of the compliance committee, I decided that was my responsibility.

Ms. DEGETTE. And you decided to hire them, right?

Mr. GORDON. Yes.

Ms. DEGETTE. And why did you do that?

Mr. GORDON. I read the charter of the compliance committee and in that it said the responsibility of the Chairman of the compliance committee and the compliance committee was to point out—

Ms. DEGETTE. And there were allegations made, and so you decided to hire an independent counsel?

Mr. GORDON. There were allegations made and it was our responsibility to hire an independent outside counsel to do that.

Ms. DEGETTE. I know.

Mr. GORDON. At the compliance committee's direction and at corporate expense.

Ms. DEGETTE. Now you told our committee staff yesterday that you had raised the concerns that you had about the large one-time charges that HealthSouth seemed to take every year. And I think as it was relayed to me, you said this did not seem to be a good way to do business.

Did you bring those concerns to Mr. Scrushy?

Mr. GORDON. I brought to him that I was concerned that we took large write-offs on a frequent basis, and that was recognized because I had never been a member of the audit committee. I was invited in the audit committee in 2002 because he said you are always interested in write-offs. Why do you not come to the committee and see what is going on.

Ms. DEGETTE. So how long had you been bringing this issue of the write-offs to Mr. Scrushy, how many years?

Mr. GORDON. I cannot tell you how many. I know on numerous occasions I said why do we have to take write-offs.

Ms. DEGETTE. Well, was it like 2002?

Mr. GORDON. Probably 2001 and 2002.

Ms. DEGETTE. Thank you.

And what did Mr. Scrushy say when you brought these concerns to him?

Mr. GORDON. That we had facilities that were closed, no locations that were no longer productive. They had to write those off and they had substantial goodwill that had to be written off.

Ms. DEGETTE. Did you go to the audit committee or to your external auditors and ask them to look further into these write-off?

Mr. GORDON. I did—on my own, I did not go.

Ms. DEGETTE. Why not?

Mr. GORDON. I was assured that this was in the normal course of business of—

Ms. DEGETTE. Who assured you of that?

Mr. GORDON. Mr. Scrushy.

Ms. DEGETTE. Now, do you know from your experience whether the audit committee had any better understanding than you do about why these write-offs occurred?

Mr. GORDON. I do not.

Ms. DEGETTE. Now, Mr. Gordon, you were also the first Board member to suggest that the Board get an inside counsel to investigate the various allegations against Mr. Scrushy. Fulbright & Jaworski was hired on September 17. And on September 18 there was an unrecorded telephonic meeting in which the Board hired Fulbright as its SEC defense counsel instead of any independent counsel. Did you participate in that telephone call?

Mr. GORDON. I participated in that meeting. I do not believe it was telephonic. The decision was made at an in-person meeting.

Ms. DEGETTE. There was an in-person meeting. When was that, do you remember?

Mr. GORDON. I believe September 17.

Ms. DEGETTE. Okay. And why did you go along with this decision about Fulbright if you were the one that suggested the independent—

Mr. GORDON. Well, I had suggested Wilmer Cutler, and I had talked to them about accepting the commission as independent counsel. I reported—

Ms. DEGETTE. But Fulbright & Jaworski was hired?

Mr. GORDON. That is right.

Ms. DEGETTE. Not Wilmer Cutler, right?

Mr. GORDON. At that meeting the name Fulbright & Jaworski came up.

Ms. DEGETTE. Yes.

Mr. GORDON. And I responded, I know the firm, they have done work for me in the past and I have high regard for them. I have no problem with them representing.

Ms. DEGETTE. So why did you then go along with them hiring Fulbright as the SEC counsel, defense counsel instead of independent counsel?

Mr. GORDON. Why did I go along?

Ms. DEGETTE. Do you understand the difference? I assume you do?

Mr. GORDON. Yes, I do.

Ms. DEGETTE. So why did you go along with that?

Mr. GORDON. Well, what I understood and I registered it in several later afterwards, I thought the compliance department had been taken out of the decisionmaking process. And if you go to further letters, I expressed that very strongly in a number of letters to Mr. Scrushy and others about my concern about how the counsel, independent counsel was selected.

Ms. DEGETTE. Okay. So now, but see, that is the problem exactly. They are no longer independent now, right?

Mr. GORDON. I had concerns about that.

Ms. DEGETTE. Well, so what happened with those concerns? Did anybody get back to you about that?

Mr. GORDON. I wrote several letters.

Ms. DEGETTE. And did you hear back?

Mr. GORDON. I finally got a response from Lanny Davis, I believe.

Ms. DEGETTE. And what did Mr. Davis say?

Mr. GORDON. Well, I had written I wanted copies of the investigation, I wanted copies of the engagement letter and so forth. And he suggested they would be forthcoming.

Ms. DEGETTE. And were they?

Mr. GORDON. No.

Ms. DEGETTE. You never heard a thing?

Mr. GORDON. No.

Ms. DEGETTE. Okay. Now, I want to ask Ms. Givens a couple of questions. You were on the audit committee, I think from its inception right?

Ms. GIVENS. No, I was on the audit committee since 1989.

Ms. DEGETTE. I'm sorry. You have been on the audit almost 15 years then, right?

Ms. GIVENS. Since 1989 until the present.

Ms. DEGETTE. Okay. Now, we have received testimony of two internal auditors that the committee rarely met with them and it was often in the presence of the full Board. We heard about this at our last hearing where they would say now we are having an audit committee meeting in the middle of the Board meeting.

The current internal auditor did not meet with your committee for a stretch of 17 months. Do you think that is vigilance on the part of the audit committee?

Ms. GIVENS. Well, I would not characterize the facts the way you have. We as an audit committee met with the internal auditors on regular basis. And, indeed, we thought that it was so important that we included them in the full Board meeting—

Ms. DEGETTE. Did you meet with them separate from the Board meetings?

Ms. GIVENS. Yes.

Ms. DEGETTE. And how often?

Ms. GIVENS. It depended on the year. But often—

Ms. DEGETTE. Okay. In 2000, how often did the audit committee meet separately with the external auditors?

Ms. GIVENS. With the external auditors?

Ms. DEGETTE. I'm sorry, with the internal auditors.

Ms. GIVENS. Well, generally we met with the internal auditors on about the same frequency as we met with the external auditors.

Ms. DEGETTE. Okay. So how many was that in 2000?

Ms. GIVENS. In 2000, it was—I do not know the exactly number, but I would say 3 or 4 times.

Ms. DEGETTE. Separate from the Board meetings?

Ms. GIVENS. Sometimes—generally the way that we worked it was that we had committee meetings prior to the Board meetings. And then the audit committee along with the external auditors would join the full Board.

Ms. DEGETTE. Would there be separate minutes then of the audit committee meeting that was before the Board meeting if that had in fact occurred?

Ms. GIVENS. There generally were.

Ms. DEGETTE. Okay. Yes, I mean we have had people come in and say that most of the time the audit committee met during the Board meeting. They would be lying if they said that? What your testimony is—

Ms. GIVENS. Again, I cannot—

Ms. DEGETTE. By the way, you are under oath. Is that you generally had separate audit committee meetings either right before the Board meeting or at different times, is that right?

Ms. GIVENS. If I can—if I can clarify for you.

Ms. DEGETTE. Sure.

Ms. GIVENS. I would appreciate it.

We regularly had audit committee meetings that were separate from the Board. In addition to that, the auditors as well as the audit committee would join the full Board to give a presentation. So that we would preclude the full Board from having to listen to all of the details that we needed to get into, but a general presentation would be made subsequently to the full Board.

Ms. DEGETTE. Okay. If you will take a look at Tab 31, the second page of that. That is the proxy statement. And what it says as a final second to last paragraph is “The audit committee met separately from the Board once in 2001.” Would that be your recollection?

It is the very bottom of the page. The third full paragraph on the page.

Ms. GIVENS. Yes. I assumed that you are referring to I think what I have tried to correct a couple of times before. The proxy reflected that the audit committee met only once during 2001. That is not correct.

Ms. DEGETTE. So this is wrong?

Ms. GIVENS. This is incorrect, that is right.

Ms. DEGETTE. How often did the audit committee meet in 2001 separate from the Board?

Ms. GIVENS. In 2001 the audit committee met, to the best of our ability in going—in going over calendars, etcetera, we met three times in person and there was an additional three times that the Chairman of the audit committee met with the auditors to go over quarterlies.

Ms. DEGETTE. And were there minutes kept at these meetings?

Ms. GIVENS. Apparently there was minutes kept of only one meeting, and that was why it was reflected that way.

Ms. DEGETTE. Whose job was it to keep the minutes of the audit committee meetings?

Ms. GIVENS. Generally we had a secretary there to keep minutes.

Ms. DEGETTE. And at the three meetings that you had in-person meetings and additional telephonic meetings, was there a secretary there?

Ms. GIVENS. There should have been. Someone named Brad Hale generally took the minutes.

Ms. DEGETTE. Do you recall Brad Hale being there?

Ms. GIVENS. I recall Brad Hale being in the vast majority of committee meetings I have been in. But I cannot tell you—

Ms. DEGETTE. Now, as a member of the audit committee, were you circulated drafts of the minutes when you met?

Ms. GIVENS. If you could just me finish my—

Ms. DEGETTE. I’m sorry.

Ms. GIVENS. [continuing] answers, it would be very helpful. Because I—please—

Ms. DEGETTE. Go for it.

Ms. GIVENS. The full answer to the last question was that I could not tell you exactly which meetings Mr. Hale was in. But he generally took notes and minutes at most of the Board meetings and the committee meetings.

Ms. DEGETTE. So as a member of the audit committee were you circulated minutes of the audit committee meetings which you had attended either in person or telephonically to review?

Ms. GIVENS. Generally, that would have been the Chairman of the audit committee would have reviewed them.

Ms. DEGETTE. You were not the Chairman of the audit committee?

Ms. GIVENS. That is correct.

Ms. DEGETTE. So your view is you never saw—you would not have seen the audit committee—

Ms. GIVENS. I saw some of them, but it was the responsibility of the audit committee Chairman.

Ms. DEGETTE. Okay. Mr. Chairman, my time has expired.

Mr. GREENWOOD. The gentleman from Florida, Mr. Stearns.

Mr. STEARNS. Thank you, Mr. Chairman. And I appreciate the gentleman letting me go forward. I have to go to luncheon, so I will just get my questions in.

I am not going to go into it, but I have a quick questions. This Mike Vines memo, which is Tab 78, it was in the summer of 2002. Let me ask staff, was this addressed to the Board of Directors or was this addressed to the—okay. So this went to Ernst & Young.

But did you folks know about Mike Vines? He said I know that HealthSouth based out of Birmingham, Alabama has severe problems in the accounting department. So this was sort of a whistleblower, a former employee and he sent this to Ernst & Young. Was this ever brought to your attention.

Mr. May, I do not think you were on the Board. Were you on the Board?

Mr. MAY. No, I was not.

Mr. STEARNS. Okay. Let me just go right on down, just yes or know, did you know about Mike Vines' memo talking about the severe problems in accounting at HealthSouth?

Mr. STRIPLIN. No, I did not.

Mr. STEARNS. Did not.

Mr. Watkins?

Mr. WATKINS. No, I did not.

Mr. STEARNS. Ms. Givens?

Ms. GIVENS. No, I did not.

Mr. STEARNS. Okay.

Mr. Gordon?

Mr. GORDON. No, I did not.

Mr. STEARNS. Okay.

Now, Ms. Givens, you are a audit committee member, Board of Directors, so I guess you are in charge of the audit committee. Did you ever hear anything about this "fleeced shareholder" letter that was sent in November 12, 1998?

Ms. GIVENS. I was not made aware of it until recently.

Mr. STEARNS. Just recently? So recently being when?

Ms. GIVENS. The last 2 or 3 months.

Mr. STEARNS. Last 2 or 3 months? So that is 5 years ago the memo was saying there is severe problems at HealthSouth, it was addressed to the company as well as Ernst & Young and you were never told of it.

Anyone else on the Board? Mr. Gordon, were you told about it?

Mr. GORDON. No.

Mr. STEARNS. Mr. Watkins?

Mr. STRIPLIN. What's the date of the memo?

Mr. STEARNS. The memo is November 12, 1998.

Mr. STRIPLIN. Well, I was—I got on the——

Mr. STEARNS. Could you bring the mike just a little closer to you?

Mr. STRIPLIN. I got on the Board in April 1999, but——

Mr. STEARNS. So you would not know.

Mr. STRIPLIN. But I would not know.

Mr. STEARNS. But even so, there was no rumor, no one ever told you about this memo——

Mr. STRIPLIN. No.

Mr. STEARNS. [continuing] describing all the problems at the corporation?

Mr. STRIPLIN. No.

Mr. STEARNS. Okay.

Let me ask you then about this pristine audits that Mr. Scruschy did. He asked Ernst & Young to go in and to see if the magazine racks were arranged and whether the toilets were clean and to do a complete audit of the facilities in terms of cleanliness, which seems a little bit unusual for an accounting firm, a large accounting firm like Ernst & Young to be doing that. Did all of you know about the pristine audits?

I mean, Mr. Gordon, did you know about it?

Mr. GORDON. Yes.

Mr. STEARNS. Ms. Givens?

Ms. GIVENS. Yes, I did.

Mr. MAY. Yes.

Mr. STEARNS. And did you know that Mr. Ernst & Young was charging more for the pristine audits, at least it looks like from the audit piece proxy disclosure, they were charging more for those audits than they were for the actual audit of the books of the company?

Mr. GORDON. No.

Mr. STEARNS. Okay. We have here a 2000 a charge to audit fees were about a million dollars and then 2001 it was a \$1.1 million. The pristine audit fees, this is to check the laboratories, the toilets, the magazine racks, the bowls in the men's room, that was \$1,250,000 in 2000. And in 2001 it was \$1,332,000. So you can see by hundreds of thousands of dollars Ernst & Young was charging more to check the magazine racks and the toilets than they were to do the audit.

Let me just go from left to right. Mr. Gordon, did you know about this?

Mr. GORDON. I saw it. I did not know about the total charges until I saw the annual report information. I knew that we were doing a pristine audit——

Mr. STEARNS. But you did not know what the figures were?

Mr. GORDON. I did not know what the figures were.

Mr. STEARNS. Okay. And Ms. Givens, you were now the audit committee Chairman, did you—you were a member, and I guess your designation is audit committee member.

Ms. GIVENS. That is correct.

Mr. STEARNS. Did you know about these figures that they were charging more for the pristine audits than actual audit of the books?

Ms. GIVENS. I did not really compare the two, but I was aware that we were paying a significant amount to oversee those facilities, yes.

Mr. STEARNS. I mean, we are going to ask Ernst & Young if they have an overseas international division doing pristine audits, but I do not think they do. This is probably one of the few they ever did. Did you find that a little unusual to have an audit firm who was doing your book to do the same thing to check all the facilities like this?

Ms. GIVENS. Well, I think that it would make sense for me to explain to you why we thought that the pristine audit was so important. This is a national health service company—

Mr. STEARNS. No, I understand. I can understand why it is important. But for your audit of people who are auditing your books to be doing it, it seems like it should be an outside maintenance company or—

Ms. GIVENS. It is the same firm, but it is not the same people.

Mr. STEARNS. Okay.

Ms. GIVENS. And Ernst & Young—

Mr. STEARNS. But it all goes to the same company?

Ms. GIVENS. Yes.

Mr. STEARNS. Okay. But I mean, you are trying to justify—are you saying today that it is acceptable for Ernst & Young to do the pristine audits and to do the audit of the company? You see no problem with that? Just yes or no.

Ms. GIVENS. Well, I would prefer not to answer just yes or no.

Mr. STEARNS. Well, it is pretty simple. The question is Ernst & Young is doing pristine audits, which is basically hotel/motel inspection of facilities at the same time you are doing the books. Do you think that is a conflict of interest? Just yes or no. You just say no or yes.

Ms. GIVENS. I think that different people were performing a task and in their respective areas—

Mr. STEARNS. Mr. Chairman, can I get a yes or no to this question?

I mean, it is just a reasonable yes or no. Was there a conflict of interest in your mind for them to be doing it?

Ms. GIVENS. No, there was not.

Mr. STEARNS. Okay. That is fine. Listen, this is all hindsight. I mean, I am asking you—I mean, I do not know anyone of us had to do your job, I am not sure how we would do it. So we are very empathetic here and we are just trying to understand it.

Let me ask Mr. Watkins, did you know about the pristine audits?

Mr. WATKINS. Yes, I was aware of it. I was not aware the actual amount split out for that portion versus the total fees that we paid Ernst & Young until—

Mr. STEARNS. And you had no idea that you folks were paying them more to check the maintenance than you were to do the books?

Mr. WATKINS. My recollection is that I did not.

Mr. STEARNS. Okay. And Mr. Striplin, did you?

Mr. STRIPLIN. Yes. I was aware of the pristine audits, but I did not—I was not aware of the fact that it was that much. Had no breakout.

Mr. STEARNS. And Mr. May, did you know?

Mr. MAY. These charges were before I came on board.

Mr. STEARNS. Okay. Now, Ms. Givens, the way they show it in the books here, it says audit related fees. I mean, do you think it is appropriate if you are doing maintenance checking of cleanliness that they would throw this into audit related fees?

Ms. GIVENS. This is a question that the Chairman and I both had and asked of E&Y, because we thought that it was a little bit odd as well. But we were reassured by E&Y that it was an appropriate—

Mr. STEARNS. Okay. In retrospect, in hindsight what do you say today? Do you think they should have had that type of service thrown into audit related fees? Because I do not find—I mean audit implies the books and there are other terms they use in the military, in the hotel business, in various businesses when you actually inspect a facility for cleanliness. But in retrospect do you think they should have included it as audit expenses?

Ms. GIVENS. That is something you will have to ask E&Y. I was relying on their expertise to categorize it properly.

Mr. STEARNS. Do you know if the company is still spending money on pristine audits?

Ms. GIVENS. I believe that we have discontinued the pristine audits.

Mr. STEARNS. And why did you discontinue?

Ms. GIVENS. If you could address that to Bob May, I would appreciate it.

Mr. STEARNS. Okay. Mr. May? And when did you stop the pristine audits?

Mr. MAY. Well, the pristine audits essentially have not been conducted to any large degree during 1930. The checklist for the operational audit still is up on our website. Our local operations are doing self audits at the time being.

Mr. STEARNS. Okay. Do you think that calling it audit related, Mr. May, is false and misleading?

Mr. MAY. Actually, I do not. During my tenure at Federal Express we had similar audits that we would call operational audits. And I think it is just a matter of semantics.

Mr. STEARNS. Was it done by your accounting firm?

Mr. MAY. Generally it was done by an internal audit group within the company.

Mr. STEARNS. That is right. But it was not done by the accounting firm who were auditing your books?

Mr. MAY. Not that I recall, no.

Mr. STEARNS. Yes. I just have about 30 seconds left. And I just wanted to ask Mr. Striplin just a question about Scrushy's salary. I just got to get this in.

In 2001 and 2002 did the compensation committee approve the bonuses for Mr. Scrusby of \$16.5 million?

Mr. STRIPLIN. As I recall, we did.

Mr. STEARNS. Yes, you did. And do you recall how the compensation committee determined that?

Mr. STRIPLIN. Well, obviously, it would not have been what it was if we had known that it had fraud in it. But—

Mr. STEARNS. Well, it turns out that in September 2, 2002, HealthSouth shareholders lost over 50 percent of the value of their stock in a matter of days. And the compensation committee approved continuing Mr. Scrusby's salary at \$1.2 million. And, you know, I guess the question is as your role as the compensation committee person on the Board, it seems like at some point when shareholders are losing 50 percent of their value, you might start looking at the salary of the CEO, just a—

Mr. MAY. Well, I do not recall the timing on that.

Mr. STEARNS. Yes.

Mr. MAY. But we always got mostly involved in the—in relationship to salaries and bonuses.

Mr. STEARNS. All right.

Thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentleman.

And recognizes the gentleman from Oregon, Mr. Walden for 10 minutes.

Mr. WALDEN. Thank you, Mr. Chairman.

I was just reading through the HealthSouth operational division 1998/99 pristine audit checklist. It is sort of a sad irony. It is a good thing to check, but number 34 was 3 people or less have a key to the cashbox or the safe combination, list names and titles. And I just find it ironic when the company's being in effect raided by allegedly the CEO and others that we got to check for a cashbox key. It is important to do, I realize, but it is still interesting.

And I do not have an objection, certainly to doing pristine audit. I mean, I was on a hospital board. We did quality control as well. We did these sorts of surveys. But we did them internally, as Mr. May, I think you have suggested is being done today. And I do think they are important because image is important, cleanliness is important; all of that. So I do not have a problem with that.

My question, though, Mr. May—well, you came on later so maybe Mr. Gordon or Ms. Givens, is how this contract—the question that gets raised is how did this contract get let? And was it sole sourced. Did you put it out for bid? Is it something Mr. Scrusby sort of negotiated with Ernst & Young on the side? Do you recall why Ernst & Young—I think the question we are all trying to get at is why Ernst & Young, not why a pristine audit.

Ms. GIVENS. A good question, and I do not know the answer to that.

Mr. WALDEN. A lot of money.

You do not know the answer to that?

Ms. GIVENS. I do not know the answer.

Mr. WALDEN. Does anybody know the answer to that? Yes, Mr. Watkins—Dr. Watkins?

Mr. WATKINS. One thing I recall is this was presented to the Board as a good thing to do for patient safety, cleanliness, etcetera, was——

Mr. WALDEN. Sure.

Mr. WATKINS. [continuing] that the idea behind using Ernst & Young was they had people in these areas, it would be less expensive we were told to have them because they would not have to travel from an airplane from corporate headquarters to inspect these in 50 States. So theoretically it would have been cheaper. As it turns out, it was not cheaper.

Mr. WALDEN. It was not true, right? And was there not some—— do I not recall reading something that the internal auditor or someone said it could be done a lot cheaper internally? Teresa Sanders, I believe said that. It is easier for us, obviously, looking back now that all the documents are here. But——

Mr. WATKINS. I do not recall specifically, but our internal audit people when they did their field audits did not inspect every facilities, whereas with the pristine audit, I think we tried to get a larger number of audits done and had a larger field force by using Ernst & Young.

Mr. WALDEN. Are you aware of any other firms that do this kind of work, pristine audit type work?

Mr. WATKINS. I am not personally aware.

Mr. WALDEN. Yes. Okay. When was the pristine audit program started? Do you remember, Dr. Watkins?

Mr. WATKINS. I don't recall.

Mr. WALDEN. Okay. All right. I want to get into some other expenditures as well just briefly.

In the "Fortune" magazine story about HealthSouth that ran, I do not know, I do not know if I have a date on it. June 23, 2003. It talks about HealthSouth spending \$13 million on two seasons of a TV show in 2001 and how Mr. Scrusby recruited Jason Hervey to become a HealthSouth executive, much to the shock of many in the firm. Are you familiar with that expenditure, anybody on the Board? Because this seems like a lot of money to go off into TV.

Mr. GORDON, do you remember that instance?

Mr. GORDON. Is the microphone on?

Mr. WALDEN. Yes, it is, sir.

Mr. GORDON. The thing I remember about that, he was promoting, and it did have some merit, about branding our company and HealthSouth would be branded throughout the United States and we have a sponsorship of TV shows. And that these could be sold to cable channels and so forth. And he presented it as being something that could be very profitable for the company. And that was the basis. That it would build a brand name, it would build a loyalty among teenagers, and so forth. And it could be sold and be profitable to the corporation.

Mr. WALDEN. All right.

Let me move on to another issue, and I think this one is probably one that concerns me as much as anything I have seen so far. This is the so-called "fleeced shareholder." I guess it is a fax. And it was sent, it says regarding HealthSouth/Ernst & Young to list is all it says. But it made its way into the company, is my understanding.

Are any of you familiar with this now or were you when it came in?

Mr. WATKINS. I am not, not at the time.

Mr. WALDEN. Ms. Givens?

Ms. GIVENS. Not at the time.

Mr. WALDEN. And you two were not on the Board. All right.

Well, it is on Tab 72 of the book there if you want to take a look. Because I think that gets to sort of a fundamental issue here as well of what do you think happened to this memo? My understanding is it went to Mr. Strong, who chairs the audit committee. And while you are reading it, maybe I could share with others.

It says "You bring the smoke, I will bring the mirrors. At least the market has shown the wisdom to devalue HS stock. Wish I got out in time. I have a list of questions which I hope might be of interest to you. How can the HS outpatient clinics treat patients without precertification, book the revenue, carry it after being denied payment? How can the company carry tens of millions of dollars in accounts receivable that are well over 360 days? How can some hospitals have no bad debt reserves? How did the E&Y auditors in Alabama miss this stuff? Are these clever tricks to pump up the numbers or something that a novice accountant could catch?" It goes on and on.

"You people and I have been hoodwinked. This note is all that I can do about it. You all can do much more. If you do is" I am just quoting. "If all you do is look into to it to see if what I say is true." And then lists distribution various places.

Do you know if this got to Mr. Strong, Ms. Givens, since you are on the audit committee? Do you know now since you did not know then? Do you know if it eventually—

Mr. GIVENS. I believe that it went to Mr. Strong, yes.

Mr. WALDEN. Okay. And do you know what happened from there on?

Ms. GIVENS. My understanding, and it is only secondhand.

Mr. WALDEN. Yes.

Ms. GIVENS. Is that Mr. Strong gave it to the auditors and that there was a full investigation with the auditors and they decided that it did not have any merit, and therefore they dismissed it and it was not brought to the full audit committee's attention.

Mr. WALDEN. Okay. And I guess that would be the next question. Do you think as a member of that audit committee it should have been brought to your attention?

Ms. GIVENS. It is hard for me to say in hindsight. I think that Mr. Strong did the right thing in taking it to the auditors.

Mr. WALDEN. Right.

Ms. GIVENS. And I think it was a judgment call on his part.

Mr. WALDEN. You are still on the audit committee today?

Ms. GIVENS. Yes, I am.

Mr. WALDEN. If a letter like this came in today, what should happen?

Ms. GIVENS. I think under the circumstances, we would pay very close attention to a letter like this. But I would use my judgment and may, indeed, give it to E&Y immediately as well.

Mr. WALDEN. But not—you would share it with the other members of the audit committee, though, would you not?

Ms. GIVENS. I think today I would, yes.

Mr. WALDEN. I would hope. I think as I have mentioned, I served on a small bank committee and on the audit committee, and I would be furious as a member of that audit committee if something like that came in, even if it's anonymous and not shared.

Ms. GIVENS. Well, I am—can I just say something to correct myself?

Mr. WALDEN. Yes.

Ms. GIVENS. I had not seen the Vines' email or the "fleeced shareholder" until recently, so I have gotten them confused. And apparently the Vines' email went to Mr. Strong, but the "fleeced shareholder" letter never went to anybody on the Board or the audit committee.

Mr. WALDEN. Oh, it did not?

Ms. GIVENS. So I misspoke.

Mr. WALDEN. All right. Then I may have misspoke, too. I was under the impression that this did get into HealthSouth because there is a memo from Mr. William T. Owens to Mr. William W. Horton—

Ms. GIVENS. That would be our legal counsel.

Mr. WALDEN. Yes.

Ms. GIVENS. And our CFO, and they may indeed have received it. But no one on the Board of the audit committee received it.

Mr. WALDEN. Okay. Because it says it is directed in your memo dated November 11, "I have completed a detailed review of the matters raised in the anonymous correspondence sent to Ernst & Young. My findings are as follows," and he goes through and details bad debt, accounts receivable over 360 days, outpatient centers, precertification.

Was Bill Owens a member of the Board?

Ms. GIVENS. He has been a member of the Board and I do know during that period if he was a member of the Board.

Mr. WALDEN. Okay. Do you think then that this should have been referred to the audit committee?

Ms. GIVENS. I would have hoped it would have been.

Mr. WALDEN. Okay.

Ms. GIVENS. I think someone on the audit committee should have seen it, yes.

Mr. WALDEN. Yes. Let me go onto something different.

Are you familiar with the FTI work, the work done by—

Ms. GIVENS. Are you speaking to me?

Mr. WALDEN. Yes, or anybody, but I assume the work done by FTI?

Ms. GIVENS. Yes, I am.

Mr. WALDEN. We were told that the FTI—actually, I am going to Mr. May, I guess. And the issue is FTI. And the work that was done by FTI, was that ever presented to the Board?

Mr. MAY. No, it was not.

Mr. WALDEN. Was the Board told that it would cost a million dollars to finish that work?

Mr. MAY. Yes. The Board was told that the current charges to FTI were approximately \$1.4 million, and it would be approximately another million dollars to complete the study.

Mr. WALDEN. And do you know who told you that and when you were told that?

Mr. MAY. Richard told the Board that in a Board meeting. I am not sure if the entire Board was assembled. I was there.

Mr. WALDEN. Do you know about when approximately, which Board meeting that was?

Mr. MAY. My recollection would be sometime in November.

Mr. WALDEN. Of 2002?

Mr. MAY. 2002, yes.

Mr. WALDEN. 2002. It is interesting, because on Tuesday, November 12, 2002 Mr.—well, L. Davis at pattonboggs.com got an email from Deborah Smith of fticonsulting.com that showed that the expenses were about \$116,756 to finish that audit. Does that sound like something you now know?

Mr. MAY. That was never communicated to the Board.

Mr. WALDEN. Even recently?

Mr. MAY. Even recently.

Mr. WALDEN. Turn to Tab 23, if you would, in the book, sir. Both of these were sent, right?

I will give you a chance to look at that.

Mr. MAY. Yes, I have looked at it.

Mr. WALDEN. Well, I am trying to figure out how to ask this. Why would Mr. Scrushy tell you it would be a million to finish at approximately the same time that this memo was being sent to L. Davis from Deborah Smith, FTI Consulting saying that \$116,000 to finish the work? And have you had a chance to look at FTI's first report now?

Mr. MAY. I saw a draft of it this week and looked at it just very quickly.

Mr. WALDEN. Just this week?

Mr. MAY. Yes.

Mr. WALDEN. Wow.

Have any of you seen the FTI draft? Have you asked for it?

Ms. GIVENS. No.

Mr. STRIPLIN. No.

Mr. WALDEN. Okay. Nobody's ask for it.

Did any of you ask why it was not finished, other the million—  
Ms. Givens?

Ms. GIVENS. I was under the impression that FTI was finished, that they had completed their work.

Mr. WALDEN. Who gave you that impression?

Ms. GIVENS. As I recall, we were told that at the Board by Mr. Scrushy.

Mr. WALDEN. By Mr. Scrushy? Was Mr. Davis present at that Board meeting?

Ms. GIVENS. I cannot recall.

Mr. WALDEN. Mr. May?

Mr. MAY. I do not recall, either.

Mr. WALDEN. Anyone?

Mr. STRIPLIN. No.

Mr. WALDEN. Would your minutes reflect that, who is in attendance at a Board meeting?

Mr. MAY. Minutes would, yes.

Mr. WALDEN. All right. We will check that.

Mr. Chairman, my time has expired.

Mr. GREENWOOD. The Chair thanks the gentleman.

And recognizes himself for 10 minutes for inquiry. And Mr. May, I would like to ask a few questions of you, if I could.

Did the Chairman of the Board Richard Scrushy ever make derogatory remarks about Board members to other Board members?

Mr. MAY. Yes, he did.

Mr. GREENWOOD. Okay. Was that typical of him?

Mr. MAY. I would say that it was—yes, it was typical.

Mr. GREENWOOD. Okay.

Mr. MAY. It became typical.

Mr. GREENWOOD. Okay. Did any Board member ever indicate to you that Mr. Scrushy had said negative things about you to them?

Mr. MAY. Other Board members said that he made negative comments about myself and John Hanson, certainly.

Mr. GREENWOOD. What kind of comments?

Mr. MAY. That he was not certain that we should remain on the Board, those sorts of comments.

Mr. GREENWOOD. Did Ms. Givens ever relay information to you about what Mr. Scrushy had told her about you?

Mr. MAY. Ms. Givens related to me that Richard Scrushy had informed here that Richard had had a private investigator investigate me, yes.

Mr. GREENWOOD. Okay. Ms. Givens, can you corroborate that, did you in fact tell Mr. May that Mr. Scrushy had a private investigator looking into him?

Ms. GIVENS. Yes, I told the full Board that.

Mr. GREENWOOD. Okay. And how did you come to know that?

Ms. GIVENS. Mr. Scrushy shared that with me.

Mr. GREENWOOD. What is your understanding as to why he would have done that?

Ms. GIVENS. My understanding was that he came upon some information which made him doubt his selection of Mr. May, and so he further investigated it.

Mr. GREENWOOD. And who did he hire to do that?

Ms. GIVENS. I have no idea.

Mr. GREENWOOD. Do you know, Mr. May?

Mr. MAY. I do not.

Mr. GREENWOOD. Okay. Mr. May, have you seen invoices for payments for a private investigator by HealthSouth?

Mr. MAY. Yes, I have.

Mr. GREENWOOD. How many invoices have you seen?

Mr. MAY. Approximately 20, and just to be accurate, I have seen the summary of those invoices, not the invoices themselves.

Mr. GREENWOOD. Okay. Did you ever ask HealthSouth's head of corporate security Jim Goodreau about whether an investigation of you had occurred?

Mr. MAY. Yes, I did.

Mr. GREENWOOD. And what did he say?

Mr. MAY. He said I did not—we did not conduct an investigation and we did not hire a private investigator to have you investigated. And if we did, I would know about it.

Mr. GREENWOOD. And who would have had the authority to hire such an investigator?

Mr. MAY. I cannot answer that question. I do not know who would have the authority.

Mr. GREENWOOD. Okay. Ms. Given, when Mr. Scrusby told you that there were some things about Mr. May might make him an inappropriate Board members did he share with you what those things were?

Ms. GIVENS. Yes, he did.

Mr. GREENWOOD. And can you share that with us, please?

Ms. GIVENS. Yes. He mentioned that he thought Mr. May was using two different names and Social Security numbers, for what purpose I do not know. He also indicated that he was associated with numerous bankruptcies and with litigation with companies with which he had been associated.

Mr. GREENWOOD. Mr. May, is that the case? Were you using two different names and two different Social Security numbers?

Mr. MAY. No, sir.

Mr. GREENWOOD. Just Mr. May?

Mr. MAY. Just Mr. May.

Mr. GREENWOOD. Okay. Ms. Givens, I am interested to know how you dealt with all of this. I mean, did you find it, as you said in your opening, you had been involved in a lot of corporate matters of corporations. Did you find it unusual that a CEO would come to a Board member and say I am having another Board member investigated because I think he is using two Social Security numbers as two separate identities?

Ms. GIVENS. Well, I think that it is more customary today than in the past to ensure that your Board members are good upstanding citizens. And so if there were something that came to his attention that made him wonder about that, I could understand why he might pursue it. However, I did ask—I did not repeat any of that information to anyone, and I asked for the report so I could see it myself.

Mr. GREENWOOD. And did you receive that report?

Ms. GIVENS. I have not.

Mr. GREENWOOD. And when did that happen? When did you have that discussion with Mr. Scrusby?

Ms. GIVENS. To the best of my recollection, it was probably the first quarter of 2003.

Mr. GREENWOOD. Okay. So, here we are in the last quarter of 2003 and you still do not know whether it was ever determined that Mr. May had a secret identity.

Ms. GIVENS. No. I asked for that report of the general counsel as well since Mr. Scrusby was removed. And I have encouraged Mr. May to find that report as well.

Mr. GREENWOOD. And it has never been found. You have never found the results of such report?

Ms. GIVENS. No. And I do know who conducted it.

Mr. GREENWOOD. You said you shared with the Board as a whole that Mr. Scrusby had told you that Mr. May was under investigation?

Ms. GIVENS. On the day that—it was on the day or a couple of days after we removed Mr. Scrusby, right after the fraud was uncovered. We had, as you can imagine, numerous Board meetings to decide how to manage the company. And during the Board meeting

where we selected Mr. Gordon to be the acting Chairman, we also—someone nominated Mr. May to be the acting CEO. And I thought it was my duty to at least let the rest of the Board know with Mr. May on the call that there were certain allegation to ensure that we were not putting in place someone else whose background might not be appropriate to serving the company. But I gave Mr. May the opportunity to respond, and he did.

Mr. GREENWOOD. Mr. May, would you turn to Tab 66? You will find there a memo that is to you and Mr. John Hanson from Fulbright & Jaworski, dated October 31, 2002. And there are photocopies attach that show shreds of documents. Do you see that?

Mr. MAY. Yes.

Mr. GREENWOOD. Okay. These were found on the fifth floor of the executive tower. The first question I have for you, whose offices were situated on the fifth floor of the executive office tower?

Mr. MAY. At the time of this memo, my recollection would be Tom Carmon, Brad Hale, Weston Smith, Bill Owens, Richard Scrusby. And there may be one or two others.

Mr. GREENWOOD. The senior management?

Mr. MAY. Senior management, yes.

Mr. GREENWOOD. Okay. Was the fifth floor easily accessible by others?

Mr. MAY. No, it was not.

Mr. GREENWOOD. Why not?

Mr. MAY. There was a fairly elaborate locking system with a card key that you needed to access to get to the fifth floor.

Mr. GREENWOOD. By elevator?

Mr. MAY. By elevator, yes.

Mr. GREENWOOD. Okay. So it would be not likely that other employees could wonder in and have shredded these documents, necessarily?

Mr. MAY. I would—I would guess not.

Mr. GREENWOOD. Okay. Looking at these shreds, you can discern what some of them say.

For example, on the last page there's a quote "7150" which is the billing code for group therapy. There is also a quote "175M based on."

When was the Board made aware that Fulbright had discovered shredded documents on the fifth floor?

Mr. MAY. I believe that Fulbright first made us aware of shredding of documents prior to me coming onto the Board, and then again in their report on, I believe, October 21.

Mr. GREENWOOD. Mr. Gordon, were you aware of the fact that these documents had been shredded and were you aware of that before you received the report from Fulbright?

Mr. GORDON. Yes. I was aware that they had found at the time they said a small amount of shredded documents on the fifth floor. That they had been placed—

Mr. GREENWOOD. Who told you that?

Mr. GORDON. I do not recall exactly who did tell me that. I do—I had heard it before the Fulbright, before it came out.

Mr. GREENWOOD. Did you not tell our committee staff just yesterday that the first time you were aware of the shredded documents was when you read about them in the Fulbright report?

Mr. GORDON. Yes, I did. That's right.

Mr. GREENWOOD. Right. So you said two different things on two different days now; which would you like to stand by?

Mr. GORDON. The first time was—I did not hear about it before the Fulbright report.

Mr. GREENWOOD. So you did or did not hear about it?

Mr. GORDON. I did not hear about it.

Mr. GREENWOOD. Your testimony today is that the first time you heard about it was when you read it in the Fulbright report?

Mr. GORDON. Right.

Mr. GREENWOOD. So you misspoke a moment ago?

Mr. GORDON. That is correct.

Mr. GREENWOOD. All right.

Mr. May, was there a discussion of hiring a firm to reconstruct the shredded documents?

Mr. MAY. Yes.

Mr. GREENWOOD. Did the special litigation committee ever issue reports or opinions from its investigation of allegations in the derivatives lawsuit?

Mr. MAY. No. The special litigation committee never did issue a report.

Mr. GREENWOOD. Okay. Okay. Mr. Gordon, would you go to Tab 15? Okay. What is that document?

Mr. GORDON. That is a letter that I wrote to Lanny Davis at Patton Boggs.

Mr. GREENWOOD. And when did you write that letter?

Mr. GORDON. On November 1, 2002.

Mr. GREENWOOD. And what does the letter mean to convey?

Mr. GORDON. It was in response to a letter that I had received by him on October 15.

Mr. GREENWOOD. And did you tender your resignation from the corporate compliance committee in that letter?

Mr. GORDON. Yes. At a previous Board meeting they had said I had conflict and they had asked me to resign as Chairman of the compliance committee. And I told them I would consider that and would confirm it back later. And I waited a week, and thought about, and confirmed that back in a letter with my thoughts on that.

Mr. GREENWOOD. Look at Tab 14, if you would. Are those the minutes from the October 29 meeting?

Mr. GORDON. Yes.

Mr. GREENWOOD. They state that you resigned from the committee at that meeting, is that correct?

Mr. GORDON. I did not resign the committee at that meeting. It was suggested that I resign, but I told them that I would consider it and get back. They asked me to resign. I did not resign.

Mr. GREENWOOD. Why did you resign?

Mr. GORDON. Why did I?

Mr. GREENWOOD. Yes.

Mr. GORDON. They quoted me, I guess, things that said I had a conflict. I had been—I had sold a company to HealthSouth and as part of the acquisition deal, I had a consulting contract. And they said that consulting contract put me into conflict.

Mr. GREENWOOD. And were those facts true?

Mr. GORDON. I did have a consulting contract.

Mr. GREENWOOD. And for how long prior to when they asked you to resign?

Mr. GORDON. That was part of the deal that was concluded in 1996. Since 1996.

Mr. GREENWOOD. Did you feel that having that consulting contract compromised your ability to act on behalf of the investors of the company?

Mr. GORDON. Sir, most certainly not. I had, as I have indicated early, \$290 million of my family's—well, my family had it at stake. And \$250,000 it was certainly not going to compromise my independence.

Mr. GREENWOOD. Okay. Back to your letter, I am going to direct your attention to the last paragraph where you wrote "I have followed closely your statements to the press about the company, the investigation and who is or is not responsible for the issues that have faced the company recently. To the extent that you" Mr. Davis you are addressing, "feel the need to address any issues regarding my service as Chairman of the compliance committee, I would expect that the circumstance under which the compliance committee was not permitted to act would be accurately and fairly disclosed as well. If this issue is not handled properly, I will consider making my own disclosure."

What did you mean by that?

Mr. GORDON. At the time I did not feel that Mr. Davis was properly respecting my position as Chairman of the compliance.

Mr. GREENWOOD. Can you elaborate on that? What made you feel that way?

Mr. GORDON. Well, what made me feel that way originally, I had proposed hiring Wilmer Cutler. That was not accepted. I thought that was my responsibility. And from that, I had a \$4,000 bill from attorneys, which I did not think was significant. Mr. Davis had indicated to me that that was a—I guess, not a good way to spend the corporate money. It was an inappropriate expenditure.

Mr. GREENWOOD. What was the \$4,000 spent on?

Mr. GORDON. My counsel had been advising me as what my duties were with the compliance committee.

Mr. GREENWOOD. Okay. Your words in the letter said "I would expect that the circumstances under which the compliance committee was not permitted to act." So what did you think was not being disclosed?

Mr. GORDON. What I thought—

Mr. GREENWOOD. And you had pretty much threatened to disclose it yourself if he didn't.

Mr. GORDON. I was Chairman of the compliance committee.

Mr. GREENWOOD. Yes, sir.

Mr. GORDON. And by the charter of the compliance committee it specifically spelled out that the compliance committee had the responsibility to select and hire an independent counsel. And I called a meeting of the committee. The committee approved this.

When it came to the Board meeting, I reported when the time come to report the compliance committee, I reported that I had been in contact with Wilmer Cutler who has had experience the

New York Stock Exchange and others, was an outstanding firm. And I would recommend they be hired.

And from somewhere in the Board a recommendation come why do we not consider Fulbright & Jaworski.

Mr. GREENWOOD. Do you know who made that recommendation?

Mr. GORDON. I do not recall. I believe it was Mr. Newhall.

Mr. GREENWOOD. And was there discussion about that?

Mr. GORDON. Was a discussion. And I responded that I have no objection to Fulbright, they had worked for me in the past in my businesses, and I was perfectly comfortable if it was the will of the Board, and I would support them.

Mr. GREENWOOD. So you have got one instance there. You are the Chairman of the compliance committee. You and the compliance committee decide that Cutler is the firm to hire. And you go to the Board and you present that. And somebody else makes another suggestion, and then you go along with it. But was that the only—when you refer to your letter “the circumstances under which the compliance committee was not permitted to act,” were there other circumstances under which the compliance committee in your opinion was not permitted to act other than this one issue of the recommendation of a law firm?

Mr. GORDON. Well, later when I found that the meeting went forward and the suggestion was made we ought to get in touch with Fulbright & Jaworski to discuss their selection, and the attorney got on the phone he said “I am really excited about working for— with HealthSouth. I have been getting myself up to speed for the last 3 days, and I am ready to hit the ground running tomorrow.”

Mr. GREENWOOD. And what did you take from that?

Mr. GORDON. I did not say anything at that time. Later in the meeting after things quieted down, I just said I have a question. And I do not understand how my duties as Chairman of the compliance committee got taken away and we did not have the final authority on this.

Mr. GREENWOOD. So it sounds to me that the choice was a fait d’accompli by the time of the Board meeting if that firm had already spent 3 days gearing up to it?

Mr. GORDON. Well, the response, Mr. Chairman, is I didn’t know what you were up to.

Mr. GREENWOOD. That is what you said?

Mr. GORDON. That’s what the Chairman, Mr. Scrusby said.

Mr. GREENWOOD. So the compliance committee ultimately had no say whatsoever about which law firm would do the investigation, is that correct?

Mr. GORDON. Yes, that is correct.

Mr. GREENWOOD. And the compliance committee itself did no review, correct?

Mr. GORDON. Repeat that, please.

Mr. GREENWOOD. The compliance committee itself did not do any kind of a review itself?

Mr. GORDON. No. It was—and then right after that I was asked to resign.

Mr. GREENWOOD. Right after that you were asked to resign?

Mr. GORDON. Yes.

Mr. GREENWOOD. My time has expired.

The gentlelady from Colorado is recognized for 10 minutes.

Ms. DEGETTE. Ms. Givens, I will admit to being surprised by your previous answers, which is why I was trying to probe. And the reason is because 3 weeks ago when we had our first hearing on this HealthSouth issue, Greg Smith, who has been the internal auditor of the company since December 1999 testified under oath that he had not met privately with the audit committee during the first 18 months he was there, except for once when he first started in December 1999. So that was the period of the 2000, half of 2001, the period where you said that the audit committee met separately at least 3 times and had some telephone conversations. And Greg Smith also told that he hasn't met with the audit committee since March 2003.

And the other reason I was surprised is because we have been provided with minutes from only one audit committee meeting during that period of time, and that was the one that Greg Smith talked about.

So I guess my question to you is, is do you think Greg Smith is lying to the committee?

Ms. GIVENS. I do not know if he is or not. I can tell you what my recollection is.

Ms. DEGETTE. But you stick by what you said earlier today?

Ms. GIVENS. Well, I think there may be some confusion about what meeting alone means. We met regularly with internal audit, very often the external auditors were there as well. And so he may be referring to meeting specifically alone as an individual with the audit committee.

Ms. DEGETTE. No, actually what he was saying is meeting with the audit committee separate and apart from meetings that were part of the regular Board meeting. That is what he was saying. And also without the other auditors.

Ms. GIVENS. Okay. Well, very often we did combine the audit function internal and external.

Ms. DEGETTE. But your testimony is you did that separate and apart from the Board meetings.

Ms. GIVENS. Sometimes—

Ms. DEGETTE. Either before it or—

Ms. GIVENS. Generally that was the case, yes.

Ms. DEGETTE. Okay. Mr. Gordon, I just wanted to follow up on one of the chairman's questions, which was you had said that this consulting contract would not—you would not feel that that gave you any kind of conflict. But legally, and I think the reason you had to step down from the Chairman of the compliance committee, is legally because of that consulting contract you would not be considered an independent director, correct?

Mr. GORDON. Well, I think it is several interpretations of that. And some things I have seen, I would be considered, others I would not be.

Ms. DEGETTE. But in the interim you have discontinued that consulting contract, correct?

Mr. GORDON. Yes.

Ms. DEGETTE. If you could, if you do not mind, take a look at Tab 28 in the notebook. And this is an SEC proxy statement for 1998. Do you see that there?

Mr. GORDON. I see schedule 14A, is that what—

Ms. DEGETTE. Yes, 14A information.

Mr. FERGUSON. Okay.

Ms. DEGETTE. Now, on the third page of that it says about the middle of the page, shareholder proposal. "The Board of Directors adopt a policy that no Board member shall serve on the compensation committee if he or she is not an independent director." And then it goes down to a definition.

Then the next page it says "The purpose of this proposal is to incorporate within the audit and compensation committee a standard of independence that will permit objective decisionmaking on compensation issues at HealthSouth." Do you see that there?

Mr. GORDON. Right now I am looking for it.

Ms. DEGETTE. It's the very top, it says page 15 of 91. It is the very top of the page.

Mr. GORDON. Okay.

Ms. DEGETTE. Have you ever seen this document before, by the way?

Mr. GORDON. I think I saw that in a proxy statement before the annual meeting.

Ms. DEGETTE. Okay. Before the annual meeting then, that would be in 1998?

Mr. GORDON. That year. Yes.

Ms. DEGETTE. Okay. And then it goes on to say on that same page 15 that HealthSouth has arranged a credit agreement with Nations Bank allowing the company to invest up to \$5 million in Acacia Venture Partners, a private venture capital fund. C. Sage Givens is the founder and the managing general partner of Acacia Venture Partners. And it goes on to say that Givens' firm recently invested \$4 million in a Managed Care U.S.A. contract. And then at the bottom of the page it says "The current members of the committee have all been directors since the initial public offering in 1996 and have served on the committee." And the basic suggestion here of the shareholders is that people who serve on the audit and compensation committee should be independent directors and should not have these conflicts.

Do you recall what the response of the Board to these proposals was?

Oh, I am sorry. And also, Mr. Watkins apparently jointly owns some property in Florida with Mr. Scrushy.

So my question is do you recall the Board talking about that proposal?

Mr. GORDON. I do, and I think the Board considered the request and came up with the decision that the members were acting in a very independent manner and they did not see the conflict.

Ms. DEGETTE. So it did not bother you that these conflict existed?

Mr. GORDON. Well, this was presented by Steel Workers or something, I think.

Ms. DEGETTE. Yes, I know.

Mr. GORDON. It was not—

Ms. DEGETTE. But still it was a proposal.

Mr. GORDON. Making changes, we were going to make some changes, but at this point we did not see anything critical in it.

Ms. DEGETTE. Right. You did not see a problem?

Mr. GORDON. At that point.

Ms. DEGETTE. And then if you will take a look at Tab 2 of the binder.

Mr. GORDON. Which one? Two?

Ms. DEGETTE. Tab 2. This is—yes, it is also 14A from April 1999. Have you seen this before?

Mr. GORDON. Where are you at? I am not keeping up with you.

Ms. DEGETTE. Tab 2.

Mr. GORDON. Okay. I am under Tab 2.

Ms. DEGETTE. At the top it says “Begin privacy enhanced message,” see that there?

Mr. GORDON. Okay. Yes.

Ms. DEGETTE. Yes. Okay. That is page 1. Then if you flip over to the second page, it says page 18 of 105 on the second page.

Mr. GORDON. Okay.

Ms. DEGETTE. And I will just tell you, this is a 14A information from April 1999, a year later, okay? And here there is a shareholder resolution that is again requesting the Board of Directors to amend the articles of incorporation and bylaws to the extent necessary to provide that at least three quarters of all Board members are “independent.” And it goes on to say “The proposal seeks to establish a level of independence that they believe will permit clear and objective decisionmaking in the best long term interests of all shareholders by the HealthSouth’s 12 directors or company insiders, 6 is the CEO of Med Partners and Mr. Scrusy as the former Chairman and current director.” And they go on to say they believe that there would be a lack of independence and that is why they are proposing that three-quarters of the Board members would be independent.

Do you recall seeing that shareholder proposal at the annual meeting in 1999?

Mr. GORDON. I do not.

Ms. DEGETTE. Okay. Do you remember any discussion about that?

Mr. GORDON. I am sure it would have been discussed. I do not recall.

Ms. DEGETTE. You do not recall a discussion?

Mr. GORDON. I do not recall.

Ms. DEGETTE. What do you think of that proposal?

Mr. GORDON. I think in retrospect looking now it has some merit. But I—

Ms. DEGETTE. Why is your consulting agreement not in this proxy, do you know?

Mr. GORDON. If it was—it was—my consulting agreement was a part of the original transaction before I became a director.

Ms. DEGETTE. Right.

Mr. GORDON. It was done in 1995, in I believe September. And part of the legal papers HealthSouth and the Chairman of the company insisted that I have a non compete for 10 years in North America. That I could not be in any—

Ms. DEGETTE. No, I understand. I am sorry, I do not mean to interrupt. We have limited time.

I understand that was your agreement, and I am not arguing about that. I understand there was consideration and everything else. But the question we are asking is about independent Board members. And the question is why was that—do you know why that was not discussed in 1999?

Mr. GORDON. As I recall, it was listed in the proxy statement in 1997, in 1998. And then after that, I think it just disappeared.

Ms. DEGETTE. Do you know why?

Mr. GORDON. I do not know why.

Ms. DEGETTE. Okay.

Mr. GORDON. I had nothing—

Ms. DEGETTE. But you still did have that agreement?

Mr. GORDON. I had a consulting contract for 10 years.

Ms. DEGETTE. Okay. And did it appear in 2000, 2001?

Mr. GORDON. I checked back, I do not believe I saw it in 2000.

Ms. DEGETTE. Who would have been in charge of listing that?

Mr. GORDON. Chief legal counsel, Mr. Horton.

Ms. DEGETTE. I just have a couple of last questions.

Yesterday we received, and I am sure all of you have seen, maybe you have not read it in depth, this indictment of Mr. Scrushy, 85 counts. And as someone who has been involved in all these corporate responsibility hearings the last few years along with the Chairman, what struck me when I read this and when we had our hearings a few weeks ago, was this was not a complicated financial unraveling like with Enron or it was not some edgy accounting like it was with Qwest or some of the other telecom companies. To me this is garden variety fraud. What you have is some accounting practices which are just plain to see.

And you have your CEO being indicted with 85 counts. You have 15 senior employees of the company pleading guilty to criminal fraud, which to me is extraordinary.

And so the question I want to ask all of you, particularly those of you who have been on the Board for longer, excluding Mr. May I would say, all of you have testified today that you have taken extraordinary steps as Board members to exercise due diligence. In retrospect, do you think there is anything the Board could have done to identify or to prevent this kind of fraud which had, as you have all stated today, seriously threatened the financial health of this company?

Mr. Gordon?

Mr. GORDON. I think when you look back on it, the Board did what were reasonable measures to perform in the best interest of the stockholders and make the management abide by the proper accounting and—when someone is determined to commit fraud, it is very difficult to find. I think that Sarbanes-Oxley will certainly be a great benefit going forward to this, because it does—

Ms. DEGETTE. But there is nothing you think the Board could have done?

Mr. GORDON. I think, you know, certainly there is something we could have done. I would not say that at all. I think that it is something that in retrospect could have been done. But the company performed very well. The earnings were—

Ms. DEGETTE. Yes, it sure did.

Mr. GORDON. Now they certainly were manipulated. But in retrospect of seeing the growth of the company over the last 5 or 6, 7 years and the performance, the first indication was the company was doing very well. Now no one had any suspicion of fraud.

Ms. DEGETTE. Okay. Ms. Givens, do you think there is anything the company could have done differently to detect this? I'm sorry, the Board.

Ms. GIVENS. I have certainly asked myself that daily since learning about the fraud last March. And I have looked at what we did as a Board, what I did as an individual and I can sincerely say that I always exercised the highest ethics, that I tried to be diligent in my duty as a Board—member of the Board. And I went out and I actually sought, I just did not fly in and fly out at Board meetings. I went out and I talked with employees. I visited facilities. We talked with the financial community. And never once did anything come to at least my attention that would lead me to conclude that there was anything wrong.

So in hindsight, I cannot think of how I would have been aware of it.

Ms. DEGETTE. Dr. Watkins?

Mr. WATKINS. I agree. We were repeatedly assured that we had the proper measures in place for compliance, detection of fraud. Our auditors in their letter to us repeatedly, as Ms. Givens has quoted, found no material evidence of fraud or other practices.

So at this point, I still do not know how we would have detected this.

Ms. DEGETTE. Well, do you think—and I know my time is close to being up, if you had had independent counsel that were truly independent, would that have helped?

Mr. WATKINS. Independent auditors or counsel?

Ms. DEGETTE. Counsel, the investigative counsel?

Mr. WATKINS. Again, I do not know. This was so widespread and this actually occurred even before—

Ms. DEGETTE. Right. So if they had been independent, would they not have found that?

Mr. WATKINS. Again, that would be pure speculation. I do not know. I do not know.

Ms. DEGETTE. Mr. Striplin?

Mr. STRIPLIN. I am not sure.

Mr. GREENWOOD. You are going to need your microphone, Mr. Striplin.

Mr. STRIPLIN. I am not sure looking forward, to answer your question, that I would ever make another good Board members, because I would be looking under every rock. And I call myself being due diligence in this situation—

Ms. DEGETTE. You do not think that that is the definition of a good Board member?

Mr. STRIPLIN. Well, I thought I was doing what I was supposed to be doing. I had no indication. If this man had been my only son, I would not feel any different than I do now. We just, all of us in shock. But the question answered—asked what would we do, I think we would, obviously, on Monday morning after you have played the game on Saturday night, you would—and you know what your mistakes were, you certainly would not go back and not

be better and be more concerned about the due diligence. You would do everything, particularly in the areas of accounting and—there has got to be consenting that we could do better.

And I think that I am so very proud of this Board of Directors of what we are doing right now, and the results that we have had. I think that Brian Marsal and Joel, and Bob have just done an excellent job. And I think that the future of this company is going to be safe.

Ms. DEGETTE. Mr. May, let me ask you, you are the captain of the ship going forward. Are there changes that can be made to the Board procedures? You know, I am not questioning the commitment or dedication of the Board members. But are there changes that the company can and will make to the Board procedures to ensure that this kind of level of widespread fraud can never happen again?

Mr. MAY. The answer is yes.

Ms. DEGETTE. And what would those be?

Mr. MAY. And there have been significant changes to our governance guidelines. There have been significant changes to our compliance program. Essentially, we have taken a look at what, you know, what are those things that we could reasonably do based on what we know today and have set in motion to put corrective action in place as quickly as possible to make sure that something like this never occurs again.

Ms. DEGETTE. Mr. Chairman, I know we are out of time. I would just ask if Mr. May would mind supplementing his answers with a brief summary of the changes that have been made toward Board governance. That would be very helpful.

Mr. MAY. I will have those to you tomorrow.

Mr. GREENWOOD. Thank you, gentlelady.

Before I yield to Mr. Walden, a couple of quick questions for Ms. Givens.

Ms. Givens, were you present at the Board meeting where Mr. Scrushy asked Mr. Gordon to resign?

Ms. GIVENS. To resign?

Mr. GREENWOOD. From the compliance committee?

Ms. GIVENS. I do not recall that, no. I do not know if I was or not. I do not recall.

Mr. GREENWOOD. Okay. Did you know whether you had an opinion as to whether he should resign?

Ms. GIVENS. No.

Mr. GREENWOOD. Okay. So you were not involved in that whatsoever? You did not have an opinion one way or the other?

Ms. GIVENS. I was not involved in that, no.

Mr. GREENWOOD. Okay.

Mr. Walden?

Mr. WALDEN. Thank you, Mr. Chairman.

This issue of hiring Fulbright & Jaworski is of interest. Because if I understand it right, Mr. Gordon, your compliance committee recommended a different firm. You took that to the Board of Directors and you presented that as your committee's recommendation. And then who is it, Mr. Newhall then recommend a different firm. Well, no. You recommended Wilmer & Cutler?

Mr. GORDON. Right.

Mr. WALDEN. Wilmer Cutler and Pickering. And it was Mr. Newhall then that recommended Fulbright & Jaworski. And then there was some discussion. How would you characterize that discussion? Was it heated, was it friendly, was it—I mean, what took place in that Board meeting, because it's not reflected? The tone is certainly not reflected here.

Mr. GORDON. That discussion was not heated, because at the time I did not suspect anything was going on. And so when they nominated Fulbright, I knew—

Mr. WALDEN. No, you nominated Wilmer, right?

Mr. GORDON. I nominated Wilmer Cutler.

Mr. WALDEN. Yes. Yes.

Mr. GORDON. And Fulbright was nominated. And I know the firm. They are an excellent firm. And they have done work for me. I have no problem with the company. If it is the will of the Board, they are fine.

Now where I got disturbed was later when I found out they had been talking to them before I gave my report.

Mr. WALDEN. And who is "they?"

Mr. GORDON. The Chairman, I believe. And perhaps Mr. Davis is what I surmised.

Mr. WALDEN. Perhaps Mr. Davis and certainly—well, the Chairman. Because when they came on the phone, was this still during a Board meeting you had the phone conversation?

Mr. GORDON. Yes.

Mr. WALDEN. They are like on speaker phone in the Board room?

Mr. GORDON. Yes.

Mr. WALDEN. And they said great thanks, we have been gearing up for 3 days?

Mr. GORDON. He said we are looking forward to going to work. We have spent the last 3 days getting up to speed on HealthSouth and we are ready to hit the ground running tomorrow.

Mr. WALDEN. So somebody had already cut this deal with them, in effect?

Mr. GORDON. That is what I suspected. I had no definite knowledge, but I suspected that.

Mr. WALDEN. But had you not already agreed to retain Wilmer?

Mr. GORDON. Yes. I had worked with a gentleman named—well, I had worked with a gentleman named Harry Wise at that firm, and he had committed he could take the assignment. And I told him I had to get Board approval.

Mr. WALDEN. Right.

Mr. GORDON. And I would get back to him just as quick as the Board met to confirm his hiring.

Mr. WALDEN. All right. And did I hear you correctly as saying Mr. Scrusy said he did not know what your committee was up to with regard to this?

Mr. GORDON. No. He said he did not know what I was up to.

Mr. WALDEN. What you were up to?

Mr. GORDON. Yes. Right.

Mr. WALDEN. All right. And do you know how he meant that? How did you interpret that? He did not know you were looking at hiring outside firm, or you did not know you were talking to Wilmer & Cutler?

Mr. GORDON. I think he, in retrospect, was concerned that I was trying to do a thorough and independent study and I do not know if he wanted one done on it that way.

Mr. WALDEN. Do you know what prompted Mr. Newhall to make this recommendation to the firm that, obviously, someone had been talking to for 3 days?

Mr. GORDON. No, other than the fact that they are outstanding firm and he was familiar with them.

Mr. WALDEN. Just sort of out of the blue he picks another name?

Mr. GORDON. I do not know if it was out of the blue, but that is the first I heard.

Mr. WALDEN. All right. Mr. May—oh, Mr. Gordon, before I leave you, on the Fulbright & Jaworski supplemental letter regarding Mr. Scrusy, the minutes on the meeting on October 29, 2002 say “The Board reviewed Fulbright & Jaworski’s supplemental letter clearing Mr. Scrusy of all allegations of insider knowledge concerning the impact of a Medicare reimbursement rule change prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 30, 2002.”

If you would turn to Tab 96 you will find a copy of these minutes, and I do believe the handwriting on here is yours and reflects, perhaps, your comments at some point. Tab 96.

Mr. GORDON. Ninety-six.

Mr. WALDEN. At the bottom of the first page, handwritten there it says “Did not clear RS of all knowledge.”

Mr. GORDON. Yes.

Mr. WALDEN. Is that your handwriting?

Mr. GORDON. Yes, it is.

Mr. WALDEN. What did you mean by that?

Mr. GORDON. As far as I was concerned, I did not think the report cleared him of all knowledge of it.

Mr. WALDEN. Why? What did you know—

Mr. GORDON. I did not know anything. Excuse me, go ahead.

Mr. WALDEN. Yes. What did you know that led you to think that?

Mr. GORDON. I did not know anything. I just from the way my handling of my chairmanship of the compliance committee, I had some suspicion. And I just did not think the report was definitive in clearing him of all knowledge.

Mr. WALDEN. On the next page, Mr. Gordon, on page 2 at the top, it says “RS” underlined and then it says “challenges Fulbright report.” I think it says “report on shredding and—”

Mr. GORDON. Other items.

Mr. WALDEN. “other items. Lanny Davis to meet with”—can you read your handwriting for me there?

Mr. GORDON. Yes. To meet with Hal Hirsch to work out wording.

Mr. WALDEN. What did you mean by that?

Mr. GORDON. When the Fulbright—original preliminary report from Fulbright came in, and it was a discussion that it had shredding in it. And he said shredding is not appropriate, it is not appropriate in that report. It should be removed.

Mr. WALDEN. Why did he say that? Did anybody question him on that; Mr. Scrusy, on why he would say shredding is not appropriate?

Mr. GORDON. Well, it was just a general conversation. It was in the document. He was instructing counsel, his counsel to discuss this with Fulbright and see if there is some way to work out getting the reference to shredding out of the documents.

Mr. WALDEN. Before it was released, before it was finalized? So Mr. Scrushy was trying to influence what was in the Fulbright report?

Mr. GORDON. Yes, I would say so.

Mr. WALDEN. And did I not read somewhere here that in part of the shredded documents that have been recovered there are some documents where they have recovered pieces that indicate transmittal or parts of the word Transmittal 1753?

Mr. GORDON. I think there was a suspicion of that, yes.

Mr. WALDEN. Then I want to go, Mr. May, to you if I could. I have before me a copy of the news release. And I do not think it is in the book, or at least in that book. It is actually in the one for the next panel, but it is the news release that was on your HealthSouth website. It is dated October 30. And it says, this is quoting you now, "This thorough outside review conducted by Fulbright & Jaworski puts to rest any question whether Mr. Scrushy had any inkling or knowledge of the Medicare reimbursement rule change or its impact prior to his stock transactions in May and July 2002." It said "Independent director Robert P. May, Chairman of the Board corporate governance committee and special litigation committee." Are those your words?

Mr. MAY. Yes, they are.

Mr. WALDEN. Did you write them?

Mr. MAY. No, I did not.

Mr. WALDEN. Who wrote them?

Mr. MAY. A collection of the lawyers who were working for the company at that time.

Mr. WALDEN. Was one of those Mr. Davis?

Mr. MAY. Yes.

Mr. WALDEN. Was he the principal author of those words?

Mr. MAY. I am not sure if he was the principal author, he was one of them.

Mr. WALDEN. Okay. Because I have also from the "Birmingham Business Journal" October 27, 2003—well, no. Yes, October 27, 2003 there is a quote and it says "Davis had a hand in writing the release and he now says" this is quoting Davis "I take full responsibility" for including May's quote embellishing Fulbright & Jaworski's conclusion, a take that didn't set well with the firm.

I want to read for you an email that we have from a Neil Gold to Hal Hirsch with a cc to Felice Gallant. Privileged and confidential. This is with regard to the news release. "Hal, this is hilarious. Is it a parody or is it for real? A few thoughts and questions. One, I did not know we had the power to clear Richard." And if you look at—well, you do not have the news release. "The first paragraph of the news release indicates that Mr. Scrushy was cleared by an outside investigation. In fact, our letter says quite the contrary," according to Mr. Gold.

"Second, what is the legal definition of inkling? Is it more than a scintilla." And the word "inkling" is used in your quote written apparently in part by Mr. Davis saying that Scrushy had—puts to

rest any question whether Mr. Scrushy had any inkling or knowledge.

“Three,” and I am quoting here, “do these idiots realize that 2 months after May 14 is July 14?”

Four, our investigation began on September 24, not September 17.” The news release says September 18. “And was essentially completed except for the supplemental reports by October 21, a period of 4 not 6 weeks.” And the 6 weeks is listed in your press release.

“Five, we did not review 59,000 documents and 546,300 pages, we merely applied our search parameters to those documents and pages. Our report specifically states that we did not examine documents not responsive to the search terms.

Six, our conclusion is not stated accurately as it omits the ‘in the view of’ clause the Fulbright & Jaworski has uncovered.

Seven, there is no way to confirm a person’s absence of knowledge.

These are just top-of-the-head thoughts about this. Have a good flight,” it says.

Do you still stand by what is in this news release and your quotes?

Mr. MAY. I am not familiar who—with the individual who wrote that email. My principal contact with Fulbright & Jaworski was Hal Hirsch.

Mr. WALDEN. Okay.

Mr. MAY. Hal Hirsch reviewed that quote. Hal Hirsch approved that quote. And therefore, yes, I stand by that quote.

Mr. WALDEN. Let me quote an email from Hal Hirsch, dated October 29, 2002, 1:30 p.m. This followed the one I quoted from Neil Gold which was at 11:52 the same day.

“Carl and I told Horton much of what you stated, though we all acknowledge a lack of control. Horton is working on improving the statement be good. HMH.”

My question is do you still stand by these statements today?

Mr. MAY. I said by the quote that was made at the time.

Mr. WALDEN. Mr. Gordon, do you think those statements are accurate in the news release?

Mr. GORDON. I would question them.

Mr. WALDEN. Could you speak just a little closer? I am sorry.

Mr. GORDON. I would question it.

Mr. WALDEN. You would question the statements in the news release?

Mr. GORDON. Yes.

Mr. WALDEN. Why?

Mr. GORDON. I guess as I have expressed earlier, I think that I do have some questions about the independence of the investigation.

Mr. WALDEN. Did you raise any objections at the time to the news release, or did you even get a chance to see it?

Mr. GORDON. I did not see it until after it was in the papers.

Mr. WALDEN. Did not see it?

One final question or set of questions. One of the things that strikes me as I listen to your testimony and having talked with you all, and with the testimony of others, was this a company that was

dominated by a CEO who engaged in intimidation and manipulation to the point that people feared for their own safety and jobs if they questioned Mr. Scrushy?

Mr. Gordon?

Mr. GORDON. Repeat that again for me, if you would?

Mr. WALDEN. I will try. Was this a company where employed and perhaps even Board members felt or today feel intimidation or that Mr. Scrushy was manipulative based on his actions? When I hear about the fact that he had his security guard, you know, follow you out of a Board meeting. You know, you hear these other things about the security arrangements at the company. And, sure, companies have those. But the taping in the back of his pickup. The fact his security guard finds the CFO committed suicide. These things sound unusual.

Mr. GORDON. Well, I think the company—or I may go back. The company was enjoying unparalleled success and people were making really good money on salary and options. So there was a lot of harmony. And I never saw a lot discord in—around the company. Everybody seemed to be very happy and working on a progressive basis. The company was growing and so forth.

Now, as things got tough over the last 6 or 8, 10 months—

Mr. WALDEN. Sure.

Mr. GORDON. [continuing] I saw some of that. I did see on occasionally when I disagreed with him, he would raise his voice and express his dissatisfaction. There was not a discussion. It was him demanding why you saying this, why you doing this, and so forth.

Mr. WALDEN. I mean, I do not know, maybe it is the way it works. But when I think about manipulation, basically saying you know, Mr. Gordon, they want you off the Board but I will keep you on if you get Mr. May off the Board and—

Mr. GORDON. He had a history of working one Board member against the other.

Mr. WALDEN. Is that not manipulation?

Mr. GORDON. I would think so.

Mr. WALDEN. Do any of you, given the indictments, given the statements, do any of you fear for your individual safety throughout this process?

Mr. GORDON. Honestly, when I drive around Birmingham at night in a Yukon that they provide me to go, I do have some concerns. I definitely do. There has been remarks that you got to be watching yourself.

Mr. WALDEN. Anyone else?

Mr. MAY. I would have to say that my wife certainly has expressed her concern for my safety. I do not have any concern.

And I also, if you would not object, I would like to just clarify my statement on my quote.

Mr. WALDEN. Sure.

Mr. MAY. What I want to be clear is that at the time I made that quote, I believed that quote to be correct.

Mr. WALDEN. How about today?

Mr. MAY. Today, you know, we understand that things are very much different and there is a different set of facts in place in terms of the conspiracy, you know, committed against the company by a

group of individuals and what information was known by those individuals during this same period of time.

Mr. WALDEN. So today you think maybe Mr. Scrusby had insider knowledge?

Mr. MAY. I think based upon what was in the indictment and what has been known, there has never been a transaction that Mr. Scrusby took part of that did not have insider information.

Mr. WALDEN. All right. Anyone else want to comment on any of this? If not, thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentleman.

Before recognizing Mr. Stearns, there are just a couple of things that are hanging out there that need to be clarified.

Ms. GIVENS, when I asked you earlier if you were present at the Board meeting when Mr. Gordon was asked, it was recommended that he be removed from the compliance committee, you either indicated that you were not there or that you do not recall being there. If you want to, you can consult—I am not sure what tab this is. I will get that for you in a moment. But I think it is 28. It is the Board meeting for October 29 at Tab 14.

Tab 14 is the Board meeting and it is from October 29. It indicates that you were at that Board meeting, and it indicates that the Board discussed Mr. Gordon's ineligibility to serve on the compliance committee because of his status as an employed consultant of the corporation.

So, now that you have looked at the Board minutes and see that they indicate you were there, does that fresh your memory and do you recall that, in fact, you were there?

Ms. GIVENS. I have not approved these minutes and one of the reasons that I did not approve the minutes was that they had me being there at some of the Board meetings where I was not. And I actually, indeed, was present at some where they did not have me recorded.

And it is also unclear as to whether or not we participated by phone or in person.

And so the fact that—and it has only been in the recent minutes where that has been a problem.

Mr. GREENWOOD. Okay. As you look at these minutes and the discussion that they reflect, is your memory jogged to recall that you in fact were there?

Ms. GIVENS. If you can give me a moment, I would be happy to do that.

Mr. GREENWOOD. Certainly. It says "all directors and guests were physically present with Mr. Scrusby in the Board room." It does not indicate that the Board members were telephonically linked.

Ms. GIVENS. This sounds familiar, yes.

Mr. GREENWOOD. Okay. So you were there when the Board discussed Mr. Gordon's ineligibility to serve on the compliance committee because of his status as an employed consultant of the corporation.

Ms. GIVENS. Yes.

Mr. GREENWOOD. During that discussion did you agree that that would be a good reason to remove Mr. Gordon from the compliance committee because of that conflict of interest?

Ms. GIVENS. As I recall that issue, that was recommended to us by our corporate counsel who let us know that he was now disqualified from being on the compliance committee.

Mr. GREENWOOD. Because of that consulting fee?

Ms. GIVENS. That is right.

Mr. GREENWOOD. Which had been around for how many years, Mr. Gordon?

Mr. GORDON. Seven.

Mr. GREENWOOD. Okay. So Mr. Gordon's got a consulting fee for \$250,000 for 7 years. He has got a multi-hundred million dollar stake in the company. And you sat there and thought that it made sense to remove him because he would have a conflict of interest because of the consulting fee, is that correct?

Ms. GIVENS. Well, that was under the recommendation by the corporate counsel.

Mr. GREENWOOD. Okay.

Ms. GIVENS. And I would have to rely on their expertise.

Mr. GREENWOOD. Right. Now, has been mentioned, you yourself had financial dealings of significantly greater magnitudes with the company, millions of dollars. Did it occur to you to say well wait a minute, if that applies to him, what about me? HealthSouth had arranged a credit agreement with Nations Bank allowing the company to invest \$5 million in a Acacia Venture Partners, a private venture capital fund with Sage Givens as the founder and managing partner. Did you say, wait a minute, if that constitutes a conflict of interest for him, \$250,000, what about me?

Ms. GIVENS. The potential conflicts of interest were always disclosed and reviewed by our internal counsel.

Mr. GREENWOOD. So were Mr. Gordon's, correct?

Ms. GIVENS. Apparently the internal counsel thought that it was inappropriate for Mr. Gordon to continue to serve. He did not mention my inability to—

Mr. GREENWOOD. I understand that. But, I mean, Mr. Gordon, they had this arrangement for 6 or 7 years. You are sitting there in the Board room. They say we have suddenly discovered—in the interim Mr. Gordon writing some strong letter questioning what is going on at HealthSouth. After Mr. Gordon starts writing these letters, the general counsel suddenly up and discovers the \$250,000 is a conflict of interest for which he should be removed from the compliance committee.

You are sitting there. Did it not go through your head that I have got multi-million dollars of conflict of interest. And if he should go, then I should go. And, in fact, according to the minutes they asked you to take his seat on the compliance committee, is that correct?

Ms. GIVENS. You have just asked me 2 or 3 questions.

Mr. GREENWOOD. Okay. You can answer them all.

Ms. GIVENS. The first one is when you talk about conflicts of interests, I would not characterize my relationship with the company as having a conflict of interest.

Second—

Mr. GREENWOOD. What did you think conflicted the interests of Mr. Gordon? What would constitute the conflict of interest? What is the difference? In other words, the theory I would assume that,

gee, Mr. Gordon would not dare question the way this company is managed because after all, they are paying him \$250,000. You know, the implication is that he would not be a good steward of the investor's dollars because he is being influenced by \$250,000 a year gain. Is that not the theory of conflict of interest?

Ms. GIVENS. In this case I really relied on our internal counsel—

Mr. GREENWOOD. Not your own judgment at all?

Ms. GIVENS. I am not a lawyer. And I relied on legal expertise.

Mr. GREENWOOD. Neither am I. I am not a lawyer. But I can understand—

Ms. DEGETTE. Will the gentleman yield?

Mr. GREENWOOD. Just a second, I will.

I can understand what this is about. This is about making sure that members of boards of directors execute their fiduciary responsibility to the investors and that their judgment in executing that responsibility is unclouded by their own personal financial interests. That is a no-brainer. Everybody understands that concept.

Ms. GIVENS. I would agree with that.

Mr. GREENWOOD. And so Mr. Gordon gets bounced off the compliance committee, you take his seat and I cannot understand why you would not say if they are bouncing him for that, what about me.

Ms. GIVENS. At no time have I thought that I have not acted in the best interest of the shareholders.

Mr. GREENWOOD. Did you think Mr. Gordon was not acting in the best interests or that he had an apparent conflict of interest? In other words, to remove your fellow Board member from the compliance committee is not about—nobody said he is not acting wisely. This \$250,000 has clouded his judgment. They said well he is getting the \$250,000, so it might appear to our stockholders and to others, our investors, that he is conflicted. So did you think he was conflicted? Did you think he was acting and using poor judgment?

Ms. GIVENS. No, sir, I did not. But I relied on the internal counsel to make a judgment as to whether or not it was appropriate for him to continue to serve. And I believe that the issue then was that he was deemed an employee of the company because of that compensation. Not that it was a conflict of interest, but the rules and regulations, I think, required that he get off.

Mr. GREENWOOD. And who was the counsel whose judgment you relied upon?

Ms. GIVENS. Bill Horton.

Mr. GREENWOOD. Mr. Gordon, you are shaking your head no. It was not Mr. Horton who made that recommendation?

Mr. GORDON. Lanny Davis.

Mr. GREENWOOD. It came from Lanny Davis.

Mr. GORDON. Yes.

Mr. GREENWOOD. You did not know that, Ms. Givens?

Ms. GIVENS. I did not.

Mr. GREENWOOD. Okay. Did you want to question—

Ms. DEGETTE. Yes. I just wanted to follow up and say if you were relying on advice of counsel and counsel said Mr. Gordon had that conflict of interest, did it not occur to you to ask counsel what

about my financial dealings with the company, or why is that different?

Ms. GIVENS. I have asked that on a regular basis, and I have always been given the response that I was not conflicted. And, indeed, most recently I had to have an independent evaluation of whether or not I was independent to be able to serve on the audit committee. And that evaluation was performed, and I have been deemed independent.

Ms. DEGETTE. Who has told you at various times that advice? What are the names?

Ms. GIVENS. Independent internal counsel Bill Horton.

Ms. DEGETTE. Okay.

Ms. GIVENS. And more recently Wilkie Farr of New York.

Ms. DEGETTE. A layer in New York?

Ms. GIVENS. A law firm in New York.

Ms. DEGETTE. Okay. Great. Thank you.

Mr. GREENWOOD. The gentleman from Florida is recognized for 10 minutes.

And I appreciate the indulgence of the panel.

Mr. STEARNS. Thank you, Mr. Chairman.

I would just say to this panel here, it is like the dentist chair. We are almost over, so we appreciate your forbearance here. And I just have the last set of questions here, right, Mr. Chairman? So after me we are all done.

There is a couple of things we just want to get on the record, so I will just take you through it.

And I will start with Mr. Striplin, if you would answer this, what was the first that the company, that you learned that the company was going to be financially impacted by the Medicare reimbursement policy about \$175 million? Was it at a Board meeting?

Mr. STRIPLIN. Yes. Yes.

Mr. STEARNS. And we understand it was, I think, in prior testimony you have given August 26, 2002?

Mr. STRIPLIN. Yes. Yes.

Mr. STEARNS. So over a year ago you were told about the \$175 million impact because of the Medicare reimbursement, right?

Mr. STRIPLIN. Right.

Mr. STEARNS. Did Mr. Scrusby tell the Board about the material impact of this \$175 million?

Mr. STRIPLIN. Yes, he did.

Mr. STEARNS. Did you have any suspicions about the announced impact on the company?

Mr. STRIPLIN. Well, we had just been told that it was going to be about \$15 million—\$15 to \$20 million, as I recall within 30 days of that. And it was sort of a shock to all of us.

Mr. STEARNS. To hear \$175 million?

Mr. STRIPLIN. That is right.

Mr. STEARNS. Go up from \$15 million to \$175 million?

Mr. STRIPLIN. That is correct.

Mr. STEARNS. In a matter of how many days?

Mr. STRIPLIN. As I recall, it was in 30 days.

Mr. STEARNS. Yes.

Mr. STRIPLIN. The prior Board meeting.

Mr. STEARNS. Do you recall the committee staff telling us that you were shocked by the amount and you felt snookered by Mr. Scrushy? Do you remember those words? We are just trying to get these on the record. I think you indicated that you were sort of flabbergasted and I think the words you used, you were shocked and snookered by Richard Scrushy. So we are just asking confirmation for the record on that.

Mr. STRIPLIN. I think I did make that statement.

Mr. STEARNS. Okay. And perhaps you would maybe just give us why you felt that way. Was it just an emotional or did you have an intellectual reason for it?

Mr. STRIPLIN. No. I just felt like that in a short period of time that we didn't know what we were talking about.

Mr. STEARNS. Yes, it was getting out of hand.

Mr. STRIPLIN. One of those kind of things.

Mr. STEARNS. Did you ever call Mr. Scrushy after the Board meeting of that August 26, 2002 to discuss the \$175 million impact?

Mr. STRIPLIN. I do not recall.

Mr. STEARNS. Yes.

Mr. STRIPLIN. I do not think I did.

Mr. STEARNS. Well, we have here you do recall it in a prior testimony, so we are just—

Mr. STRIPLIN. Well, remind me.

Mr. STEARNS. In fact, you said yes and then you went on to say you asked Mr. Scrushy, you said "What the hell is going on here with this number." That is what, Mr. Striplin, you told us, the staff here. So we are just trying to get it on the record.

Mr. STRIPLIN. Well, if I said that, I think that it was true.

Mr. STEARNS. Okay. I mean, it is a pretty quote, what in the hell is going on.

Mr. STRIPLIN. Yes.

Mr. STEARNS. I think that was a good quote. Yes.

I guess the next question is after you said that, what did Mr. Scrushy say to you?

Mr. STRIPLIN. I do not recall. I was known to confront a lot on different things.

Mr. STEARNS. Oh, you were?

Mr. STRIPLIN. Yes.

Mr. STEARNS. Do you recall, this is what you told our staff, you said that Mr. Scrushy responded "We have just got some things we have got to charge off." Do you remember him or recall him saying that to you?

Mr. STRIPLIN. I do not really recall that. But if I said that at the time, I did remember it.

Mr. STEARNS. Okay. All right.

Mr. STRIPLIN. Yes.

Mr. STEARNS. Did you ever tell any other Board members about this conversation, your feelings and your conversation with Mr. Scrushy? I mean, this is a pretty big impact. It goes from \$15 million to \$30 million to \$175 million. At some point did you share this with other Board members?

Mr. STRIPLIN. Not that I recall.

Mr. STEARNS. Let me ask the rest of the Board members if the conversations that we have just had did Mr. Striplin, Mr. Gordon, tell you anything about his conversation with Mr. Scrushy in which he said what the hell is going on and Scrushy oh, we're just charging off a couple of things? Do you remember that?

Mr. GORDON. No.

Mr. STEARNS. Ms. Givens?

Ms. GIVENS. No, I do not.

Mr. STEARNS. And Dr. Watkins?

Mr. WATKINS. No.

Mr. STEARNS. And Mr. May?

Mr. MAY. I was not aware of the conversation.

Mr. STEARNS. Okay. I guess, Mr. May, you were not there at the time.

Let me go then, Mr. Gordon, if you would be so kind, we are going to Tab 90. And I will take a moment here for you to get to Tab 90. And specifically I am talking about page 2 at the bottom of the page. This Tab 90 represents minutes of the February 7, 2003 Board meeting, and I draw your attention to the bottom that states "Mr. Scrushy also advised the Board that he was seeking approval from the Board to leave Dr. Watkins' stock options open until their normal expiration date as part of his agreement to be available to consult with the Board on an as-needed-basis. After discussion upon mother duly made by Mr. Striplin and second by Mr. Newhall, the following motion was approved with Mr. Gordon abstaining."

So the question is in the whole matter of life do you remember that, Mr. Gordon, abstaining?

Mr. GORDON. Yes, I do.

Mr. STEARNS. Okay. I guess the question we are all asking is why did you abstain?

Mr. GORDON. I abstained because I had recognized Bill's excellent service to the Board and I thought Dr. Watkins had been a very capable Board member. But he had options that were remaining outstanding that expired over the next 6 or 8 years. And I did not think it was appropriate that a Board member who resigned should maintain his stock options. If he resigned, he could exercise them at that point. But he was not entitled to maintain them over the next 6 to 8 years. So I discussed the fact that I did not think it was appropriate for him to have his options extended that long.

Mr. STEARNS. That sounds like a square shooter. I think you are saying something that most of us would all agree with. But what did Mr. Scrushy say about why Dr. Watkins' stock options should be extended? I mean, did he say something in a meeting that you recollect?

Mr. GORDON. Yes. He says let us let him have them, we might need him to testify sometime.

Mr. STEARNS. He said we might need him to testify. Now, testify, what did you think he meant when Mr. Scrushy said let us give him the stock option and by so doing would you not consider that quid pro quo or some kind of salve here to get him in case he has to testify, that he would be on the right side; is that not what you are saying? That is the implication.

Mr. GORDON. In my mind, I thought that was the implication and I thought it might be flip. I did not really know if he was making a flip or not.

Mr. STEARNS. So Mr. Scrusy said he might be called to testify. Now "called" does not mean by the Board.

Mr. GORDON. I think he might be required to testify.

Mr. STEARNS. Must be required. So that would require the law would ask him to testify. Would that be a safe understanding in your estimation, somebody beyond the Board? Because the required is not voluntary. So Mr. Scrusy at that point was saying maybe in an indirect fashion that, hey, we had better be nice to this fellow because he might be required to testify under oath.

So my question to you is did that send up any flags?

Mr. GORDON. At that time things were coming to a conclusion that they would eventually receive, and I think at that time, you know, the comment was suspect, to say the least.

Mr. STEARNS. Yes. Well, Mr. Watkins, I guess you are next here. So the question is the obvious thing here is it looks like a quid pro quo just from the outside. So did Mr. Scrusy give—did you have any conversations now that this was sort of a quid pro quo; we will give you a stock option, if you are required to testify you will work with us?

Mr. WATKINS. Never. In fact, I have never thought that until this very minute that he said to the Board.

As part of my agreement when I resigned from the Board, I simply requested that I be allowed to keep my stock options. They were all under water. They were worthless, but my feeling was it was a reward for 18 years of service. It was not unusual business practice to let a Board member continue to have their options. And I agreed to be a consultant and help in any way with the company. But I never have heard that quote before. And Richard Scrusy did not say that to me. He may have expected that, but I certainly never would have done that.

Mr. STEARNS. Mr. Scrusy never talked to you about this idea that if you will resign, you will get your stock options? He never mentioned anything like that to you?

Mr. WATKINS. No. No. Actually, I brought it up. I asked if I do go ahead and resign, is it okay if I go ahead and just keep my stock options. I know they are under water, they are worthless, but I would like to keep them because I have faith in this company. And I will be glad to work for it.

Mr. STEARNS. Okay. Had you ever heard what Mr. Gordon said before? You said this is the first time you have ever heard that Mr. Scrusy said he may be required to testify?

Mr. WATKINS. Absolutely. I have never heard that before.

Mr. STEARNS. Okay. Anybody else know anything? Okay.

Let me move to my last, Mr. Chairman, series of questions here. And this is to Mr. May.

If you would be so kind to turn to Tab 25, it is one page. It is a memorandum to George Strong from yourself. You are acting chief executive officer. This is dated June 11, 2003.

Mr. MAY. Actually the date that is on the memorandum is not—that is the date this memorandum was printed. The timeframe in

which the memo was originally created and sent to George, was back in March 2003.

Mr. STEARNS. The date on the memo from George Strong is wrong?

Mr. MAY. Correct.

Mr. STEARNS. And the date should be March 2003?

Mr. MAY. Correct.

Mr. STEARNS. And is it just what? The computer puts it out, when the set of computers some date, or tell me why the wrong date here. I mean, how would you argue that it is the wrong date when it says "6/11/2003?"

Mr. MAY. I know when I created the document.

Mr. STEARNS. Okay.

Mr. MAY. And when it was printed for the committee.

Mr. STEARNS. Okay. Let me just review this. I will sort of paraphrase because you know the thing.

The main point of this memo, and I will not laboriously go down and read it, but the question was are there any Enron type issues or exposure here. Ernst & Young focused heavily on those type of items when evaluating our books. And what Mr. Strong said "What assurance can we have from Ernst & Young that next year we do not have the same issues? Obviously, if we do the consequences would be disastrous. I leave this question in your hands to handle as you deem appropriate."

So, I guess what about Mr. Lamphron's statements to the Board prompted you to raise these issues with the Chairman of the audit committee?

Mr. MAY. There were a couple of things. At that meeting we were handed a set of minutes for approximately the last 12 months to approve. I asked that they must be given to me to review before given to a whole Board to be approved. I took those minutes with me and at that Board meeting, E&Y, this is the year end, E&Y gave their year end report about the work that they had done in the previous year and how the Board could rely on E&Y's assurances that the books accurately reflected the business, etcetera, etcetera.

So on the way home I was reading these minutes to review them, and came upon the minutes from the previous year's meeting, same time. And those minutes reflected in 1901 the extensive work that E&Y did in taking a look at our books and records in light of the fact that Enron and WorldCom and all of those companies had made the news that year.

Mr. STEARNS. Yes.

Mr. MAY. So at the Board meeting in Orlando that happened in 2003 for a year end 2002, I heard similar assurances from E&Y and at that same Board meeting there was—we had our fourth quarter earnings report where we had significant write-offs.

Mr. STEARNS. \$600 million charge was inconsistent with—was there not a \$600 million dollar write-off?

Mr. MAY. Correct. So my question was with such a careful examination, why are we having a \$600 million charge off.

Mr. STEARNS. Now, again, like we talked about these with this Striplin, was this not presented at the eleventh hour? I mean, it is sort of like just came out under the cracks, \$600 million charge?

And was this not sort of inconsistent with the eleventh hour call, as you understand it?

Mr. MAY. I believe that we were—the Board was notified of the charge off the day prior to the earnings release, I believe. If that is your question.

Mr. STEARNS. And what was your reaction to that? I mean, did you have the same reaction as Mr. Striplin and say what the hell is going on?

Mr. MAY. I certainly had a lot of questions as to why the Board was not given more notice than the day prior to the earnings release.

Mr. STEARNS. When these things happen like this, do they—when you go home at dinner at night, I mean do you say, hey we got to do something here. Something is going on here. Tomorrow morning I am getting up early and I am going in there and heads are going to roll.

I mean, what did you do in terms of activity the next day with this?

Mr. MAY. You certainly, you know, ask yourself those questions; what is it that you can do to get at answers. And then I think—

Mr. STEARNS. But you just took the answer as credible and moved on?

Mr. MAY. The answer to what, sir?

Mr. STEARNS. That the \$600 million popped up?

Mr. MAY. No, I would not say we took the answer as it was laid out. We wanted to have answers as to why the charge offs were, you know, were to the size that they were.

Mr. STEARNS. Yes.

Mr. MAY. And then certainly simply a few weeks later is when the revolution of the fraud occurred.

Mr. STEARNS. Did you ask him why it came up so soon and so unexpectedly? And what was his reply?

Mr. MAY. The question was—I believe was answered or asked on the call that we had prior—the evening prior to earnings release as to why, you know, we were given such notice. And the answer was that there was a lot of complicated things that needed to be done at the year end.

Mr. STEARNS. Who gave you that answer, just for the record? Who gave that answer that—

Mr. MAY. I cannot—

Mr. STEARNS. [continuing] certain things just came up?

Mr. MAY. I cannot be certain exactly who gave me that answer. But I believe it was Bill Owens.

Mr. STEARNS. I assume it must have been the chief financial officer?

Mr. MAY. Again, I am not certain, but I believe it was Bill Owens.

Mr. STEARNS. Okay. What was the response of Mr. Strong? Did Mr. Strong respond to your suggestion, your memo?

Mr. MAY. Mr. Strong indicated verbally to me that, you know, it was something that he would look into and make sure that we got answers on.

Mr. STEARNS. Did he actually get answers on this?

Mr. MAY. I am not certain. You would have to ask George. But as I said, a couple of weeks later or just a few weeks later, you know, the world fell apart with the fraud disclosure.

Mr. STEARNS. Let us move until today. You are sitting in your desk operating now as the acting chief executive officer. If this had occurred to you today, what would be your response?

Mr. MAY. If this type of write-off occurred at your end?

Mr. STEARNS. If you were notified in such short notice like you were, I mean if you had the same thing happen to you today, I assume your behavior might be a little different?

Mr. MAY. I would say I would look——

Mr. STEARNS. Would you accept the fact that somebody told you these are just some write-offs, nothing to worry about?

Mr. MAY. No, I would throw them out the door.

Mr. STEARNS. I think that is what you would do, yes.

Thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentleman.

The Chair thanks the panel.

Ms. Givens, just one final request. If you would, either you or would you have your attorneys send us a copy of the report that they determined your independence with regard to the audit committee, that would be helpful for our inquiry.

Ms. GIVENS. Be happy to.

Mr. GREENWOOD. We thank all of you for being here for these many hours. We wish all of you and HealthSouth well as you try to reconstruct this company into the future.

Thank you.

And we are going to recess now until 2:30. And we will take the third panel at that time.

[Whereupon, at 1:58 p.m., the subcommittee recessed, to reconvene at 2:37 pm. the same day.]

Mr. GREENWOOD. The committee will come to order. We welcome the third panel, who have already found themselves to the table.

Let me introduce you, Mr. Richard Dandurand. Am I pronouncing that right?

Mr. DANDURAND. Yes, Mr. Chairman.

Mr. GREENWOOD. All right. Is the former engagement partner on HealthSouth account at Ernst & Young; Mr. Wayne Dunn is the former senior manager on HealthSouth account at Ernst & Young, and; Mr. James Lamphron is a former engagement partner on HealthSouth account at Ernst & Young.

Gentlemen, as you may know, this committee takes its testimony under oath, and so I need to ask if any of you object to giving your testimony under oath this afternoon.

Mr. DANDURAND. No, I don't.

Mr. GREENWOOD. Okay. I need to also advise you that pursuant to the rules of the House and this committee, you are entitled to be represented by counsel. Do you wish to be represented by counsel this morning? Okay. And are you all represented by the same counsel?

Mr. DANDURAND. That's correct.

Mr. GREENWOOD. Okay. Mr. Lamphron, would you identify your counsel by name and point to them, so we know who they are?

Mr. LAMPHRON. Sitting directly behind me is Steve Farina and Matt Harrington of Williams & Connelly.

Mr. GREENWOOD. Okay. Very well.

In that case, I am going to ask if you would stand and raise your right hands.

[Witnesses sworn.]

Mr. GREENWOOD. Okay. You are under oath. And it is my understanding that Mr. Lamphron is going to give an opening statement of approximately 7 minutes for all three of you.

Mr. LAMPHRON. That is correct.

Mr. GREENWOOD. That is fine. And the floor is yours, sir.

**TESTIMONY OF JAMES P. LAMPHRON, FORMER ENGAGEMENT PARTNER ON HEALTHSOUTH ACCOUNT AT ERNST & YOUNG; RICHARD DANDURAND, ENGAGEMENT PARTNER, HEALTHSOUTH ACCOUNT AT ERNST & YOUNG; AND WAYNE DUNN, FORMER SENIOR MANAGER ON HEALTHSOUTH ACCOUNT AT ERNST & YOUNG**

Mr. LAMPHRON. Thank you.

Good afternoon, Chairman and members of the subcommittee.

My name is Jim Lamphron and I am a partner in the firm of Ernst & Young. Beginning with the audit for the year 2000 I served as the engagement partner with responsibility for the financial statement audits that we performed for HealthSouth.

I am here this morning with my colleague Wayne Dunn, who for the last several years has been the senior manager on the engagement, and my former partner who is now retired, Dick Dandurand. Dick was the engagement partner on HealthSouth before I took over.

I am 56 years old, married for 34 years, and have 3 adult children. After completing my undergraduate degree and serving as an officer in the Marine Corps, I became an auditor in 1975. That was with the firm of Arthur Young & Company that later merged in 1989 with Ernst & Whinney to form the firm of Ernst & Young. Both firms were founded approximately 100 years ago, and today Ernst & Young employs over 25,000 people in the United States.

First let me say that, to a person, we at Ernst & Young feel for and share the outrage of the many upright and decent people at HealthSouth, and in the investing community who have been harmed by this fraud. Investors, retirees and employees have all been harmed. As a resident of Birmingham, I can attest that the entire city has suffered and will continue to suffer from the aftereffects of the fraud perpetrated at HealthSouth.

I don't know of another fraud that is quite like. According to the Department of Justice and the SEC, a specific aim of the criminal conspiracy was to undermine and sabotage Ernst & Young's work as auditors. The fraud is also unprecedented in terms of management involvement. Yesterday, the company's founder and CEO, Richard Scrushy was indicted on 85 counts of fraud and other charges. And as you know, 14 other HealthSouth executives have already pled guilty, including every former CFO. And the U.S. Attorney in Birmingham says that the indictments will continue, and that her probe is extending further into non-financial areas of the company. As you observed at the first of these hearings, Chairman

Greenwood, HealthSouth presents the unique and uniquely troubling story of a corrupt criminal enterprise.

At the outset, let me try and answer a few of the questions that I think you may have.

People ask me how a fraud of this scale could go undetected by the auditors. The U.S. Attorney has stated over and over again that we were a target of the collusive fraud. We were given fake documents, altered documents, and were lied to, over and over again. Through the collusion among the senior management of HealthSouth, our audit was impeded and undermined. As Teresa Sanders, the former head of Internal Audit at HealthSouth, testified before this subcommittee, and I will say as Mr. Wallance testified before this subcommittee this morning, when you have a collusive fraud involving multiple members of management and where documents are falsified, it is entirely possible to defeat a financial statement audit.

People ask me if, in hindsight, there was one more thing that I or my team would have done. I have asked myself that question many times since March 19. I have looked back through our work papers. I have tried to find that one string that, had we yanked it, would have unraveled this fraud. I know we planned and conducted solid audits. We asked the right questions. We sought out the right documentation. Had we asked for additional documentation there or asked another question there, I think that it would have generated another false document and another lie. With each guilty plea that is announced, we see where the fraud was systematically expanded to undermine our audit procedures.

Finally, people ask me what is the likelihood of this happening again. The shorter answer is that there is no system, no audit and no law that can be made invulnerable to a collusive band of criminals. Character and ethics cannot be legislated. That said, I believe our system has been significantly strengthened of late, the requirements and procedures legislated by Congress in the Sarbanes-Oxley Act will, in my estimation, make another fraud of this type less likely. In fact, it may be that the requirements for officer certification and harsh criminal penalties is what brought down the walls of silence around this fraud. The new rules being adopted by the SEC and The New York Stock Exchange will also promote corporate accountability and improve corporate guidance.

I also believe the U.S. Attorney in Birmingham should be praised for her vigorous prosecution of this case. And the hearings being held by this subcommittee will undoubtedly be constructive in publicizing the aftereffects of the fraud further, so as to discourage others from following the same path.

Finally, let me say, I have spent almost 3 decades building my professional reputation. The criminals that ran HealthSouth exploited many people, including me and my colleagues and throughout the firm. In a very personal way I share the anger and frustration of this subcommittee, the investing public and the Birmingham community.

Mr. Chairman, we have worked to assist you and your staff in every respect during the course of the subcommittee's investigation. I am happy to answer the subcommittee's questions, as are my colleagues.

[The prepared statement of James P. Lamphron follows:]

PREPARED STATEMENT OF JAMES P. LAMPHRON

Good Morning Mr. Chairman and members of the Committee. My name is Jim Lamphron and I am a partner in the firm of Ernst & Young. Beginning with the audit for the year 2000 I served as the engagement partner with responsibility for the financial statement audits Ernst & Young conducted for HealthSouth Corporation. I am here this morning with my colleague Wayne Dunn, who for the last several years has served as senior manager on the HealthSouth audit. My former partner Richard Dandurand, now retired, also joins me. Dick was the engagement partner on HealthSouth before I took over.

After completing my undergraduate degree and serving as an officer in the United States Marine Corps, I became an auditor in 1975. That was with Arthur Young & Co., which combined with Ernst & Whinney in 1989 to form Ernst & Young. Both of the predecessor firms were founded approximately 100 years ago, and today Ernst & Young employs more than 20,000 people in the United States.

First let me say that, to a person, we at Ernst & Young feel for the many outstanding and decent people at HealthSouth and in the investing community who have been harmed by the HealthSouth fraud. Investors, retirees and employees have all been harmed. Residing in Birmingham, as I do, I can attest that the entire city has suffered and will continue to suffer from the aftereffects of the fraud perpetrated at HealthSouth.

I don't know of another fraud that is quite like HealthSouth. According to the Department of Justice and the SEC, a specific aim of the criminal conspiracy at HealthSouth was to undermine and sabotage Ernst & Young's work as auditors. The fraud is also unprecedented in terms of management involvement. So far, fifteen HealthSouth executives have pled guilty to fraud, including every former Chief Financial Officer. And the US Attorney in Birmingham advises that the indictments will continue, and that her probe is extending further into non-financial areas of the company. As you observed at the first of these hearings, Chairman Greenwood, HealthSouth presents the unique and uniquely troubling story of a corrupt criminal enterprise.

At the outset, let me try and answer a few of the questions that I think you may have.

People naturally ask me how a fraud of this scale could go undetected by the auditors. The US Attorney has stated over and over again that we were a target of the collusive fraud. We, the auditors, were given fake documents, altered documents, and were lied to, over and over again. Through the collusion among the senior management of HealthSouth, our audit was impeded and undermined. As Teresa Sanders, the former head of Internal Audit at HealthSouth, testified before this Subcommittee, when you have a collusive fraud involving multiple members of management and where documents are falsified, it is entirely possible to defeat a financial statement audit.

People ask me if, in hindsight, there was one more thing that I or my team should have done. I have asked myself that question many times since March 19th. I have looked back through our workpapers. I have tried to find that one string which, had we yanked it, would have unraveled the fraud. I know we planned and conducted solid audits. We asked the right questions. We sought out the right documentation. Had we asked an additional question here, or asked for an additional document there, I am convinced that the fraud and deceit would have expanded to generate another lie, another fake document. With each guilty plea that is announced, we see where the fraud was systematically expanded to undermine our audit procedures.

People also ask me about internal controls and if HealthSouth had appropriate controls in place. A simple example of an internal control that is probably familiar to all of us is the requirement of two signatures on checks of a certain size. That is a classic internal control, and is drawn from a basic insight about human nature: a one-person crime is far more likely than a two-person crime. The internal controls at a large corporation are an application of the same principle, albeit often more complex. We look to see that multiple layers of people and departments are involved in different transactions. We look for sign-offs. We look for documentation. What did my team do at HealthSouth? We did all those things and more. HealthSouth had in place a formidable system of internal controls. Could those controls be circumvented by a fraud that encompassed the entire senior management of the company? The unfortunate answer is yes.

Finally, people ask me what is the likelihood of this happening again. The short answer is that there is no system, no audit, and no law that can be made completely invulnerable to a collusive band of criminals. Character and ethics cannot be legis-

lated. That said, our capital market system has been significantly strengthened of late. The requirements and procedures legislated by Congress in the Sarbanes-Oxley Act will, in my estimation, make another fraud of this type less likely. It may be, indeed, that it was the requirement of officer certifications and the threat of harsh criminal punishment that finally brought down the walls of silence surrounding the HealthSouth fraud. New rules being adopted by the SEC and the exchanges will also promote corporate accountability and improve corporate governance. The US Attorney in Birmingham should be praised for her vigorous prosecution of this case, which sends the right message. And the hearings being held by this Subcommittee will undoubtedly be constructive in publicizing the aftereffects of the fraud so as to discourage others from following the same path.

Mr. Chairman, we have worked to assist you and your staff in every respect during the course of the Subcommittee's investigation. I am happy to answer the Committee's questions, as are my colleagues.

Mr. GREENWOOD. Thank you, Mr. Lamphron. I appreciate that. And thank you for your cooperation thus far, thank you for your corporation in the next hour or so.

Has Ernst & Young, as you have reviewed documents that describe how this fraud was perpetrated, and as you have even recently I am sure you have read the indictment where a lot of this is set forth, has Ernst & Young changed any of its procedures? Have you sat around the table and brainstormed how you might change procedures so that this does not happen again?

Mr. LAMPHRON. Well first, Mr. Chairman, let me say that we really have not been able to examine documents relating to the fraud. We have, of course, gone back and reviewed our work papers, our procedures, our processes.

The firm has addressed this and other situations. For example, we early adopted many of the provisions of the new auditing standard on fraud. We did that in 2002.

We have conducted extensive training of our people. As an example in the past year or so I have been to 40 hours of training dealing with Sarbanes-Oxley, SAS 99 fraud awareness.

Mr. GREENWOOD. But when you say have not been to see documents, what I want to know is have you had the opportunity, I mean HealthSouth still exists, it is under new management, you have some new people on the Board and so forth, have you been able to go in and look at documents within the company at all?

Mr. LAMPHRON. We have not.

Mr. GREENWOOD. You have not? And why is that?

Mr. LAMPHRON. I am not sure. I—I—

Mr. GREENWOOD. Have you asked for the opportunity?

Mr. LAMPHRON. We have been—I have been led to believe that we do not have access to the documents.

Mr. GREENWOOD. And who led you to believe that?

Mr. LAMPHRON. Well, in general conversations with my attorney.

Mr. GREENWOOD. That you do not have access to—that Ernst & Young cannot go back and look? In other words, I understand you reviewed your work papers. But, obviously, there are—and I do not know whether it may be the case that the Justice Department has ceased all these documents, you do not have access to them for that reason. Is that your understanding?

Mr. LAMPHRON. Well, that could be part of it. Another reason might be because Pricewaterhouse is in the process of conducting a forensic audit. They are not through with that. My understanding is it will be some time before they release their findings.

Mr. GREENWOOD. Okay. So is it fair to say that this company through fraud, there is no dispute about that, and you guys were lied to—

Mr. LAMPHRON. Correct.

Mr. GREENWOOD. And you were lied to to the tune of \$2.4 billion dollars of the phony income that they got by you that you were not able to know; you still do not know how they did that?

Mr. LAMPHRON. Our knowledge of that is limited to the things we have read in the press. Probably, maybe even less than the extent that you know.

Mr. GREENWOOD. Yes. Okay. Have you had a chance to review the indictment?

Mr. LAMPHRON. I have scanned the indictment and discussed it with our attorneys.

Mr. GREENWOOD. Okay. Let me ask you to turn to Tab 78 in the binder, please. And I am going to ask all of you to look at that.

Mr. Lamphron and Mr. Dunn, this is the email from former HealthSouth employee Michael Vine to Ernst & Young in which he asserted that there were “severe problems with the company’s accounting, particularly with respect to the capitalization of expenses in certain accounts.”

When and how were you first made aware of the allegations in this complaint?

Mr. LAMPHRON. I was made of that when, as you may see there, the email was sent to one of our national websites and on July 1 that email was routed to me.

Mr. GREENWOOD. Okay. And what did you do with that email?

Mr. LAMPHRON. Immediately I called our professional practice director, that is the person in our consulting chain. I informed him of the contents of the email. And together we planned to discuss what we should do, our communications and our investigation.

Mr. GREENWOOD. And did you inform HealthSouth about the allegations?

Mr. LAMPHRON. I did. I made a call the very next day. This was July 2. Near the July 4 holiday. The only person I could reach at that time was Weston Smith, who was controller at the time. I informed him of the allegations. I asked for a—to see if we could put together a conference call with Richard Scrushy, Bill Owens and himself.

Mr. GREENWOOD. Did you inform the audit committee at HealthSouth about this?

Mr. LAMPHRON. Not right at that time, but later I did. I had—

Mr. GREENWOOD. When was that?

Mr. LAMPHRON. That was after we had—the company had conducted their investigation, after we had talked to them, after we had conducted our independent investigation. And then I talked to the Chairman of the audit committee and informed him of our findings. And at that point he indicated he was satisfied with what we had done.

Mr. GREENWOOD. So how did you proceed to looking into this? What did you do to satisfy yourself with regard to this memo internally as Ernst & Young?

Mr. LAMPHRON. Sure. The first thing we did was, of course, notify the company and give them an opportunity to—a brief period

of time to perform their own investigation to see if there were anything to these allegations.

We met with them a few days later. They discussed——

Mr. GREENWOOD. And let me stop you there. Is there such thing as a standard operating procedure when an auditing firm receives a tip from an outside party alleging misconduct on the part of a client?

Mr. LAMPHRON. Absolutely.

Mr. GREENWOOD. At least in retrospect, my inclination would be well, gee, if my client is cooking the books, I am not sure that the first thing I want to do is to tip them off to the allegation. I might want to look at it internally ourselves to see if we are missing something. Because, as you said in your opening statement, if they want to go back and give you another false statement, it would not be hard to do.

Mr. LAMPHRON. Well, there is two pieces of auditing literature, SAS 54, illegal acts, and SAS 99 on dealing with the detection of fraud during an audit, both of which say if something like this occurs, we are to communicate to management at a level higher than where the issue or the fraud was reported, which we did. And in fact, went all the way to the audit committee level.

Mr. GREENWOOD. Did Mr. Owens ever suggest that Mr. Vines might have had a motive behind his allegations?

Mr. LAMPHRON. He did. When we met with him after they had conducted their investigation, they mentioned that Mr. Vines had been fired during a few months previous to this.

Mr. GREENWOOD. Did they say why?

Mr. LAMPHRON. Yes. They said he had been—had several instances of I think it was fraternizing with women in the department or women he had been supervising. He had been warned about it by human resources. Had been on several occasions. And in a final case had been released.

Mr. GREENWOOD. Did you review Mr. Vines' personnel record to verify that?

Mr. LAMPHRON. I did not.

Mr. GREENWOOD. Okay. Did you try to contact Mr. Vines personally either by phone or email to gain fuller understanding of his allegations before commencing the investigation?

Mr. LAMPHRON. Well, I did but I would first say that his——

Mr. GREENWOOD. When did you do that?

Mr. LAMPHRON. I did that after discussing our findings with the Chairman—I did try. Let me clarify that. No I did contact him.

Mr. GREENWOOD. But still after you went to the company? In other words, when the email came in, you looked at the email, his email address is not—is right on there. You did not attempt to engage him directly in a conversation?

Mr. LAMPHRON. I did not. If you—you know, reading the email you can see that it was very, very specific and down to the point of identifying the specific accounts that were affected. We thought at that point we had enough knowledge to conduct our investigation.

Mr. GREENWOOD. Okay. But you did not think it would have been prudent if you had contacted him first?

Mr. LAMPHRON. No. Again, I felt like we had enough direction in his email to begin the investigation.

Mr. GREENWOOD. Before commencing your review, did you make any attempt to discover which division of HealthSouth Mr. Vines worked in or which business units or regions of the company Mr. Vines had responsibility for in order to better focus your inquiry?

Mr. LAMPHRON. Well, we knew that he worked in fixed assets, in which division, I do not think we knew at the time. But we—

Mr. GREENWOOD. You knew that because the company told you that?

Mr. LAMPHRON. But we expanded our investigation to include all divisions.

Mr. GREENWOOD. Okay. Did you know at the time that he worked in the in-patient division, and did you know that this business unit of nationwide responsibility was unit three?

Mr. LAMPHRON. Well, at the time I did not, but that is not entirely correct. He handled in-patient facilities and also handled 500 out-patient facilities. Between he and his two cohorts, they handled all 1881 facilities.

Mr. GREENWOOD. But did you know that he had sole responsibility for unit three?

Mr. LAMPHRON. No, I knew there were three people who divided the work up. And, again, we tested records from all three divisions.

Mr. GREENWOOD. Is it true that you only learned about Mr. Vines' position in the in-patient division after he testified in April 2003 at the Scrusby Asset Forfeiture hearing?

Mr. LAMPHRON. That is correct.

Mr. GREENWOOD. Okay. Is it not also true that you did not learn which business units Mr. Vines had responsibility for until after committee staff inquired about them to you doing a recent interview?

Mr. LAMPHRON. I do not know.

Mr. GREENWOOD. Okay. Let us turn to the actual review you did. I understand that Ernst & Young requested that HealthSouth provide all reclassifications from the three accounts mentioned by Mr. Vines in his email, is that right?

Mr. LAMPHRON. That is correct.

Mr. GREENWOOD. Okay. I also understand that in two of the three schedules of reclassifications provided to you by HealthSouth, there were no reclassifications from business unit No. 3, the business unit for which Mr. Vines had principal nationwide responsibility. Did you notice that at the time of your review?

Mr. LAMPHRON. No, because that is not correct.

Mr. GREENWOOD. Okay. Help me out.

Mr. LAMPHRON. There were reclassifications from business unit three, which we examined and found them to be appropriate.

Mr. GREENWOOD. But in only in one of the three accounts, is that correct?

Mr. LAMPHRON. I do not know.

Mr. GREENWOOD. Okay. Mr. Dunn, do you know?

Mr. DUNN. I do not know the answer to that, no sir. I believe a couple of the accounts did not have 03, but I do not know if it was only one.

Mr. GREENWOOD. Okay. I do not know if you are able to check your records, but the staff is telling me that you went over with them when they interviewed you.

Mr. DUNN. We did—we did discuss that. And what I am saying is I recall that it was not on a couple of the schedules we had, but I do not recall that we had all the schedules that I investigated at the time. If we remember our interview, we talked about the fact that I only kept certain of the documents. And so I did not know if there were items from 03 for the other ones I did not retain.

Mr. GREENWOOD. And when did you first learn that the data runs provided by HealthSouth did not include any unit three reclassifications in two of the three accounts? Is it not true that the committee staff had to recently point this out to you in an interview?

Mr. DUNN. Say that again, please.

Mr. GREENWOOD. When did you first learn that the data runs provided by HealthSouth did not include any unit three reclassifications in two of the three accounts?

Mr. DUNN. I do not know when I first learned that. I do not know if I learned it at the time of the staff or if I had seen it previously. But we did discuss that with the staff.

Mr. GREENWOOD. Okay. So given the fact I assume that you did not audit any of the reclassifications from business unit three and two of the three accounts noted by Mr. Vines in his email, is that your understanding? You did not audit any reclassifications from business unit three in two of the three accounts noted by Mr. Vines in his email?

Mr. DUNN. In two of the three accounts related to the information we had—

Mr. GREENWOOD. There were 7072 and 7995—

Mr. DUNN. I do not know the specific accounts, but I know it was two of the accounts, and I do not know which period it was. I do not know if it was the December period or the May period.

Mr. GREENWOOD. Okay. So it is correct that you did not audit two of these three accounts for business unit three?

Mr. DUNN. For two of the three accounts there were not reclassifications associated with business unit three on some of the periods. And so we would not have any samples from business unit three.

Mr. GREENWOOD. And with respect to the third account for which HealthSouth provided Ernst & Young reclassifications from business unit three, you did not sample or review any unit three reclassifications below \$5,000, is that right?

Mr. DUNN. I do not know the answer to that. I am sure it is in the information we provided, but I do not know the answer to that.

Mr. GREENWOOD. Okay. Staff says that is correct.

So given that Mr. Vines' concerns dealt with unit three reclassifications below \$5,000, I take it that your conclusion that his allegations were unfounded is it itself unfounded?

Mr. DUNN. Well, I would point out that the email he sent did not alleged any specific amounts. It just said reclassifications in those accounts. So, you know, based on that there was not a reason we would specifically look for items under \$5,000.

Mr. LAMPHRON. Mr. Chairman, if I may?

Mr. GREENWOOD. Yes, please.

Mr. LAMPHRON. First, let me tell you we took this allegation very seriously. Mr. Dunn and I decided on our audit approach. Between the two of us we have got 40 plus years of experience. And to the best of our ability, we designed an approach to determine if his allegations were correct.

Now, I know that under oath in Federal court Mr. Vines testified that his two co-workers, who between the three of them, encompass every facility the company has, they were all engaged in fraudulent activities. Our review encompassed all the divisions for several months. And so at the time we thought what we did was sufficient.

Mr. GREENWOOD. But when he sent the email, I mean the thing that struck us and the staff, and it is puzzling, is this is such a specific email. This says "If you look under three rocks, you will find three smoking guns."

Mr. LAMPHRON. Yes.

Mr. GREENWOOD. And it tells you exactly what to find. And what we are trying to understand why it is that it seems like in fact the thing to have done with someone who has got that specific information, would have been to get in contact with him immediately and say tell us exactly where to look.

Mr. LAMPHRON. Yes. Well, again Mr. Chairman, because the email was so specific, we did not feel like we needed to do that at this point.

Now, even today—

Mr. GREENWOOD. But Mr. Dunn was just saying, we did not have specific enough—I mean, on one hand we are hearing you say we did not have specific enough information to know where to look. On the other hand, you are saying the information was so specific we did not have to ask where to look. Which is it?

Mr. LAMPHRON. Well, it is that we—our review encompassed every division for several months. And if what Mr. Vines says is true, that his two cohorts were involved in that, and again he said that in Federal court under oath, then our review should have discovered it.

Now, I need to say that even at this date we do not know that what Mr. Vines was talking—mentioned in his email has anything to do with this fraud that we are here today to discuss. In fact, through counsel, Mr. Owens, the—

Mr. GREENWOOD. You are not saying you know that it did not. You are just saying that you do know that it did?

Mr. LAMPHRON. We do not know that it did. And we know that Mr. Owens subsequent to pleading guilty to the fraud charges, indicated that this was not how they did the fraud. And, of course, us not having access to the corporate records at this point, we have had no opportunity to go back and see if it was part of this fraud or if it was not.

Mr. GREENWOOD. Okay. My time has long since expired.

The gentlelady from Colorado is recognized.

Ms. DEGETTE. Thank you very much, Mr. Chairman.

Following up on the Chairman's questions, now you were in the independent—and by the way, I do not know which of you did what, so rather than waste my time saying what do you know,

chime in—you know, speak up when I ask these questions if you know the answers, okay?

Mr. LAMPHRON. Yes, ma'am.

Mr. DUNN. Yes, ma'am.

Ms. DEGETTE. Thank you.

Now, you all were engaged as the independent auditors for HealthSouth, correct?

Mr. LAMPHRON. That is correct.

Ms. DEGETTE. Now you received this now infamous email from Mr. Vines, June 2, 2002, the one you were just talking to the Chairman about, correct.

Mr. LAMPHRON. Correct.

Ms. DEGETTE. Now in this email it said "In December 2001 HealthSouth moved expenses to capital accounts." And then it lists specifically three accounts as of December 31, 2001, correct?

Mr. LAMPHRON. Correct.

Ms. DEGETTE. Now, what you have testified to, Mr. Lamphron, is then what you did when you found this out in late June, you contacted the Board, I believe. Or who did you contact?

Mr. LAMPHRON. I contacted—

Ms. DEGETTE. You contacted Mr. Owens?

Mr. LAMPHRON. Mr. Owens, Mr. Smith, Mr. Harris and George Strong.

Ms. DEGETTE. And you gave them an opportunity to research this internally, and that is standard operating procedures for you?

Mr. LAMPHRON. That is correct.

Ms. DEGETTE. Correct?

Mr. LAMPHRON. Yes.

Ms. DEGETTE. How long did you give them again?

Mr. LAMPHRON. I first made them aware of this either on July 2 or July 3 and we met with them on July 8. And they reported their findings and we began our independent investigation then.

Ms. DEGETTE. Now, when you began your independent investigation since, as you have testified, you had three specific account numbers that Mr. Vines gave you, what did you do? Did you ask the company to provide you with information on those accounts?

Mr. LAMPHRON. That is the only way that we get access during the audit process. We ask—

Ms. DEGETTE. Did you ask them to provide all the information on those accounts as of December 31, 2001?

Mr. LAMPHRON. We asked them—we selected 2 months during the 2001 year.

Ms. DEGETTE. And what months were those?

Mr. LAMPHRON. Those were May and December and asked for all the reclassifications from those three accounts, and actually one more during those 2 months.

Ms. DEGETTE. Okay. And take a look at Exhibit 79 in your notebook. These are listings of some of the 7200 accounts from December 31, 2001. Mr. Dunn or Mr. Lamphron, whoever, does that look like the information they gave you, the company gave you?

Mr. LAMPHRON. It does not look like the information he gave me.

Ms. DEGETTE. Okay. Well, what I would like you to do, the both or if you want to, all three of you, flip through this exhibit. And I will tell you what it is. We got this exhibit from Mr. Vines. And

what it shows is that for a number of 7200 accounts it shows capital internet costs, page after page after. Three pages of it. Attached to that are what look like some ledger pages showing a variety of expenses being reclassified as software capital internet costs. Can you see that in flipping through Exhibit 79 there?

Mr. LAMPHRON. Yes.

Ms. DEGETTE. Now, what it looks like to me is there is these accounts, like on the first page it says Florence Carpet & Tile, Inc., \$541.73. Further down the page DoobyDoo Grease Exhaust System. On the next page Nasif's Texaco. And it goes on and on like that. Hobart. Moody's Sprinkler Company. Ace Glass Service. It is pretty clear in looking at these ledger sheets that these are all expenses from all of the HealthSouth facilities. Would that be fair to say?

Mr. LAMPHRON. Yes.

Ms. DEGETTE. But then when you look at it, he is transferring it to capital accounts. Do you see that there, Mr. Lamphron? If you look at, it says software capital internet costs. On those pages where it says Florence Carpet & Tile and all of those.

Mr. LAMPHRON. Yes.

Ms. DEGETTE. Okay. And then you will have to take my word for this because we have gone back through and looked at it, and gone through it with Mr. Vines. You can trace these numbers here back to the numbers on the first page by looking at both the facility number and the amount.

Now, I do not know about you, but you guys are trained professionals. If you had this information, I would think Mr. Dunn, Mr. Lamphron, you would say something is not right here. Would that be accurate?

Mr. LAMPHRON. Very accurate.

Ms. DEGETTE. But you did not have this information, did you?

Mr. LAMPHRON. We did not.

Ms. DEGETTE. What you had was simply maybe not this list, but lists of information like this that the company gave you that just showed capital internet costs, right?

Mr. LAMPHRON. Correct.

Ms. DEGETTE. So there is no way Ernst & Young would have been able to figure out that this information had been transferred to a capital—which is, by the way, pretty standard basic accounting fraud, right?

Mr. LAMPHRON. Yes.

Ms. DEGETTE. Capitalizing expenses?

Mr. LAMPHRON. Yes.

Ms. DEGETTE. That is pretty basic.

Mr. LAMPHRON. Yes.

Ms. DEGETTE. I only had to take accounting 101 to know that. So, I mean, but if you did not have this, you would not know that this was fraudulent, right?

Mr. LAMPHRON. Right.

Ms. DEGETTE. And you would not have known that that was fraudulent unless you talked to Mr. Vines, right? Just based on what the company's giving you, you're never going to be able to find out where this information came from, right?

Mr. LAMPHRON. That is as we have subsequently learned, that is correct.

Ms. DEGETTE. Right. And see, the problem is when you have widespread fraud going on, it is the fox guarding the hen house. Because you are asking the company that you are supposed to be independently auditing for the information that they are not doing what Mr. Vines says they are doing specifically. He said they are capitalizing expenses, right?

Mr. LAMPHRON. That is correct. But—

Ms. DEGETTE. Now, I think probably it would be fair to say that if you had to redo this today, you would have called Mr. Vines, right?

Mr. LAMPHRON. Do what?

Ms. DEGETTE. If you had to redo this independent investigation?

Mr. LAMPHRON. Well, I tried to call Mr. Vines.

Ms. DEGETTE. Oh, you did?

Mr. LAMPHRON. I did.

Ms. DEGETTE. And what happened?

Mr. LAMPHRON. I placed three phone calls, got no answer. On the third call I left—I identified myself, indicated I was with Ernst & Young and asked him to call me.

Ms. DEGETTE. Did you try to try to email him?

Mr. LAMPHRON. I did not.

Ms. DEGETTE. Did you know that it was his phone? Did he—was his voice on there identifying himself?

Mr. LAMPHRON. I am not sure how the message was at the time. But it is the number that is identified in his email.

Ms. DEGETTE. And when did you try to contact him?

Mr. LAMPHRON. After we had our discussion with the Chairman of the audit committee. And we thought it would be appropriate to follow up with Mr. Vines.

Ms. DEGETTE. When was that?

Mr. LAMPHRON. Sometime later in July. I am not sure of the exact date.

Ms. DEGETTE. Yes. By then, later in July, if you felt you had done enough, you had been all the way through the audit committee, why were you trying to call Mr. Vines then?

Mr. LAMPHRON. Mr. Strong, Chairman of the audit committee felt it would be appropriate to sort of close the loop with Mr. Vines, tell him our findings and to—

Ms. DEGETTE. Let me help you out. Because in your notes it says: “also decided to communicate with employee and let him know we had followed up on his concerns,” and found nothing of any concern, right?

Mr. LAMPHRON. That is right.

Ms. DEGETTE. So that is why you were trying to call him? You had done your investigational calling and said there is nothing wrong, right?

Mr. LAMPHRON. To let him know the results.

Ms. DEGETTE. Yes.

Mr. LAMPHRON. That is right.

Ms. DEGETTE. Okay. Now, the indictment that came down against Mr. Scrushy yesterday said that HealthSouth had manufactured \$370 million in cash accounts on its balance sheet. My question is does not Ernst & Young as an auditor send out con-

firmation letters to a client's bank to see if the cash claimed on the balance sheets actually exist?

Mr. LAMPHRON. We do. We do not send them out to every account. In the case of HealthSouth—

Ms. DEGETTE. How much of a company's cash accounts do you attempt to verify?

Mr. LAMPHRON. Well, let me say that they had over 2600 cash accounts.

Ms. DEGETTE. Right. So how many of those letters—

Mr. LAMPHRON. We selected a sample choosing the most—the largest balances, the most active accounts and sent confirmations to those.

Ms. DEGETTE. How many was that, do you know?

Mr. LAMPHRON. I think it was around 50.

Ms. DEGETTE. Fifty out of 2600?

Mr. LAMPHRON. That is right.

Ms. DEGETTE. Do you think that that's within industry standards for an independent audit?

Mr. LAMPHRON. Absolutely.

Ms. DEGETTE. Did all those accounts have money in them or were they zero balance accounts?

Mr. LAMPHRON. A number of them had money in them. Some were zero balance.

Ms. DEGETTE. How many of the 50 had money in them?

Mr. LAMPHRON. The 50?

Ms. DEGETTE. Yes.

Mr. LAMPHRON. I do not know.

Ms. DEGETTE. Is it not true that most of your audit was on this pristine audit? Most of your time was spent on this pristine audit?

Mr. LAMPHRON. Absolutely not.

Ms. DEGETTE. Okay. You spent all of your time on the books?

Mr. LAMPHRON. I spent virtually zero time on the pristine audits.

Ms. DEGETTE. Well, what about other members of Ernst & Young?

Mr. LAMPHRON. No one has—who was part of the engagement team except, as I understand, maybe in the very first year to get the program off and going, was involved in the pristine audits. We—

Ms. DEGETTE. But, in fact—

Mr. LAMPHRON. We had separate engagement teams.

Ms. DEGETTE. Okay. But overall, the money that Ernst & Young was paid was paid more for doing pristine audits than for doing financial audits.

Mr. LAMPHRON. Well, that is not correct either.

Ms. DEGETTE. That is not correct?

Mr. LAMPHRON. Not in any year did the fee for the pristine audits exceed our fee for doing audit work for the company.

Ms. DEGETTE. Okay. Thank you for clearing that up. Because that is not the information that we were given.

Mr. LAMPHRON. Okay.

Ms. DEGETTE. But we will follow up in a few minutes.

I yield back right now.

Mr. GREENWOOD. The gentleman from Oregon, Mr. Walden, 10 minutes.

Mr. WALDEN. Thank you, Mr. Chairman.

I wonder if any of you at the panel is familiar with a firm known as CFRA? Does that ring a bell?

Mr. LAMPHRON. I have—the first time I heard of them was a day ago.

Mr. WALDEN. Okay.

Mr. DUNN. Same thing.

Mr. WALDEN. Okay.

Mr. DUNN. Earlier this week.

Mr. WALDEN. Because, our staff has found a memo, perhaps provided by you all. Well, it is from 1995 to Ernst & Young from CFRA where they appear to have done a rather thorough look at HealthSouth. And on the cover of this memo on Ernst & Young letterhead, dated April 3, 1995, it is to G. Marcus Neas.

Mr. LAMPHRON. Neas.

Mr. WALDEN. Neas from James P. Conley. It says HealthSouth Corp. Have you seen this? It is under Tab 69 in the book.

Mr. LAMPHRON. I have seen it, again, yesterday.

Mr. WALDEN. And you have read it?

Mr. LAMPHRON. Yes, sir.

Mr. WALDEN. Okay. Do you have any idea what the purpose of this memo was, why it was done, why it was requested?

Mr. LAMPHRON. I would assume James Conley, Jim Conley was a senior partner in our professional practice director group. A consulting partner.

Mr. WALDEN. Why would he have this in his possession?

Mr. LAMPHRON. Well, I can only guess and assume that somehow this report came to his attention. He read it, he voiced his concerns through this memo to Mark Neas, the engagement partner at the time. And I would suspect that Mr. Neas responded back by April 19 as he was asked to do.

Mr. WALDEN. Except nobody can find the copy of that response, is my understanding.

Mr. LAMPHRON. Well, that is my understanding also. But I would like to add that, again, Jim Conley was our senior consulting partner. Very experienced, very knowledgeable, very well respected in the firm. And I have total confidence that he would not have let this drop.

Mr. WALDEN. Okay.

Mr. LAMPHRON. Mark Neas got back to him, I am certain of.

Mr. WALDEN. Then why would he put on here please do not copy or send the report to the client?

Mr. LAMPHRON. I do not know.

Mr. WALDEN. Would that be standard on these sorts of reports; someone senior in your company would say don't share this report with a client?

Mr. LAMPHRON. Well, I do not know. I would not say that is standard. I do not know how he came to have this report. It, you know, this report could be confidential, it could be for subscribers to a newsletter or something. We just do not know.

Mr. WALDEN. Okay. But he had it, so it is in your firm? And your firm is on retainer at this point to do the audits for HealthSouth, right?

Mr. LAMPHRON. Right.

Mr. WALDEN. Okay. Because I would like to just—Mr. Chairman, I am sure all this is in the record, but as I read it today for the first time, it strikes me as really this company CFRA appears to have detected the disease that was running throughout HealthSouth back in 1995. And it says things like “We would question the motive of any company that takes a large write-off in the immediate aftermath of an acquisition by writing off \$49.7 million on the date of the acquisition, however HealthSouth gives the appearance of ‘clearing the deck’ of expenses that would otherwise have to be charged in future periods against operating income.” Now, we know from testimony from Mr. Gordon that he began to have some concerns about rather large write-offs that took place every year. And I have seen in other documents concerns like that as well.

They go on to talk about accounting for startup and related costs and how some of these startup—how HealthSouth capitalizes organization, partnership formations and startup costs and subsequently amortizes such costs over 3 years. Go on. And then they say “We feel that such costs should be expense as incurred since they appear to constitute ordinary recurring operating expenses.” And we know later on that while maybe not specifically here, certainly in their payments they tried to amortize or capitalize payment under 5,000 as a way to hide from you all the opportunity to look at those accounts.

Mr. LAMPHRON. Yes, sir.

Mr. WALDEN. They go on to talk about a weak control environment. It says “In general, we feel the outside members of a public company’s Board of Directors should lack any significant affiliation with either the company, its executive officers or other Board members outside their services as directors and their ownership stake in the company. We also advocate the Board should be comprised of individuals with a diverse set of experiences and perspectives. Furthermore, we feel a public company should avoid engaging in any significant related parties transactions with either its directors officers or any relatives of such directors or officers. As outlined below, HealthSouth’s Board appears lacking with regard to such criteria.”

Then they go through the various relationships among Board members citing specifically Strong, Givens and I think Chamberlain, it would indicate here, perhaps, and how they are interrelated with Scrushy.

Then they go on talking about CEO compensation. “On a more sober note, we would argue the willingness of a company to engage in the wholesale repricing of options granted to its CEO and other executive officers, in effect all such offers to “have their cake and eat it, too.” We consider such an approach a clear transfer of wealth to executive option holders from other company shareholders. If they do this, they ought to be explicitly reported in the annual proxy statement.”

And when apparently they tried to do a more generous stock option, it was voted down in 1994. And they say “We are nevertheless troubled by HealthSouth’s attempt to implement a plan that institutional investors who reported led the charge against the stock option plan would consider out of bounds.” I raise this because these

all appear to be things that came up again and again, now as you go back and look. And you all, somewhere the very upper echelons of your company had this in your possession. And you say somebody, obviously, responded to it because you know these people.

Are these issues, as you audited the company, you discovered on your own as well? Were they ever identified?

Mr. LAMPHRON. Well, these issues, as best I can tell, every one of them that is mentioned was available in public filings. These are things we were aware of.

For instance, the \$49 million write-off.

Mr. WALDEN. Right.

Mr. LAMPHRON. We were aware of that. We audited it. It was totally proper. And, in fact, was required by accounting standards. What he suggests that it be made a part of the purchase price allocation is not good accounting. It is not the rules.

Mr. WALDEN. All right. Did you or your auditors feel that management was dominated by one or a few individuals without effective oversight by the Board of Directors or the audit committee?

Mr. LAMPHRON. We were—I assume you are—

Mr. WALDEN. I am referring to Tab 78, I believe it is. “Wherein your internal documents under management’s control consciousness and operating style.” Apparently year after year this box was checked on your internal documents. That and management’s excessive interest in maintaining or increasing the client stock price or trend earnings. Those were both checked yes?

Mr. LAMPHRON. Yes.

Mr. WALDEN. These were issues you were concerned about then and how Mr. Scrushy ran the company?

Mr. LAMPHRON. Well, let me say the point of this document is to help us assess internal controls at the entity level.

Mr. WALDEN. Okay.

Mr. LAMPHRON. Not over cash receipts, cash disbursements, but over HealthSouth.

Mr. WALDEN. Okay.

Mr. LAMPHRON. We were aware that Mr. Scrushy had a strong personality.

Mr. WALDEN. Understatement.

Mr. LAMPHRON. And that he was involved in the day-to-day operations of the company. And that is what that response means.

Mr. WALDEN. Okay.

Mr. LAMPHRON. Now, having a strong personality does not mean you are engaged in fraud. There are a lot of very successful companies that have leaders like that.

Mr. WALDEN. Sure. In fact, most have that.

Mr. LAMPHRON. What it tells us is it is an element. It is a risk element and we assess that in the context of the entire internal control environment.

Mr. WALDEN. Mr. LAMPHRON. Let me give you an example.

Mr. WALDEN. Okay. Go ahead, give me an example.

Mr. LAMPHRON. Well, let me give you an example. On something like that with a dominant personality as the CEO, we would look to see for things like was he personally presenting accounting issues to us. Did we feel like he was pushing the envelop on ac-

counting issues. Did we feel like he was pushing his CFO and controller. And that is not the thing we found. In fact——

Mr. WALDEN. Okay. Let me go to a point then. Because also in your monitoring checklist it is checked yes that internal audit is not adequately staffed or trained, does not have appropriate specialized skills given the environment. Internal audit is not independent, authority and reporting relationships and does not have adequate access to the audit committee or equivalent. The scope of internal audit's activities is not appropriate. Balance between financial and operational audits, coverage and rotation, decentralized operations. And internal audit has limited authority to examine all aspects of the client's operation or fails to exercise its authority.

All four of those are also checked.

Mr. LAMPHRON. Yes, sir. That was our acknowledgement that we were not in our audit process going to place much reliance on the work that internal audit did. I mean, let me say that prior to today, and there was no requirement. Until yesterday, as a matter of fact, that a company has to have an internal audit department.

Mr. WALDEN. Right.

Mr. LAMPHRON. Second, if they choose to have one, there is no direction that says here is what they have got to do.

Mr. WALDEN. All right.

Mr. LAMPHRON. And companies can choose to employ them several ways. They can direct them toward operational auditing or exclusively in operational areas, which we knew that is what they did. And what that meant to us is we are not going to place much reliance on their work. In fact, we replaced the hours that another internal audit department, let us say, that did financial auditing; we essentially replaced all those hours. So we put in thousands of hours doing the kind of work that internal audit might do.

Mr. WALDEN. Then why the next year in comments and additional information would you—whoever wrote this say “Overall, we believe that management has designed an environment for success. As a result of this environment, management has designed sufficient controls and oversight functions in order to prevent instance of material misstatement of the financial statements. We believe the management is ethical, competent and fully aware of all potential business developments.”

If you had some of these other concerns over the years about the internal audit committee not really being properly trained, having appropriate access to books and things, was it your view then that you all had all that access and so the internal audit was not that——

Mr. LAMPHRON. Well, with respect to internal audit, it just meant that we had to do the work, which we did. And those are just several of the factors in many, many factors in assessing the internal control environment.

Mr. WALDEN. Did you ever share those concerns that you say you had about the internal control environment, concerns that led you to replace the hours that otherwise would be done; did you ever share any of that with the audit committee, the Board or management?

Mr. LAMPHRON. No.

Mr. WALDEN. Why?

Mr. LAMPHRON. Because they were well aware of it. We were at meetings when internal audit—at Board meetings when internal audit reported the scope of activities. We knew the Board and the audit committee were well aware of the charge that internal audit had. And that was operationally based. I mean, that is a management decision as to—and a Board decision and an audit committee decision as to how you are going to employ those resources.

Mr. WALDEN. Did you ever recommend changes? Did you ever see—I guess what I struggle with is, for example, there is a boxed check here. It says “Management’s excessive interest in maintaining or increasing the client’s stock price earnings trend” is checked yes.

Mr. LAMPHRON. It is checked yes, but let me say I would be—

Mr. WALDEN. That would be a red flag, I would—

Mr. LAMPHRON. Well, we did not take it as red flag. It is just our acknowledgement that this is a public company and their focus is earnings, like probably most if not all public companies focus on earnings. So it is—I would not at all call it a red flag. It was another factor for us to consider in designing our audit.

Mr. WALDEN. I am just trying to put myself in the place of one of those Board members relying on you who have far more experience than they do at this sort of look. And I guess, and maybe I am just misreading all this, I look at it and say there was something that caused whoever filled out this forms year after year to say management is probably a little more aggressive than most, and he would not have checked yes. I mean, is that not accurate? There are internal auditing control issues that need to be watched. And yet none of that gets conveyed to the Board. So they do not think you are seeing anything wrong. In fact, you are telling them they got controls, right?

Mr. LAMPHRON. Yes, sir. Let me say that how they employed internal audit, how management and the Board—

Mr. WALDEN. Right.

Mr. LAMPHRON. [continuing] decide to use them—

Mr. WALDEN. It is totally their decision?

Mr. LAMPHRON. It is their decision. So we do not mark it up as hey, that is a weakness. That is how they choose to do it.

Mr. WALDEN. So that was not in your responsibility—

Mr. LAMPHRON. Right.

Mr. WALDEN. [continuing] when you analyzed the company for outsiders to look at?

What if internal audit said you have access, the internal auditors do the corporate books, too? I mean, they did not, but—

LAMPHRON. I am not sure what you are asking. I am sorry.

Mr. WALDEN. Well, my point is what if management had said, okay, we are going to have our internal auditor to do 33 other things, and you say, you know, looking at it from the inside I do not think they are doing it right, but that is not my view. That is not our responsibility. So to heck with that. We will go do our thing, ignore that. We do not have a responsibility to tell the Board anything about what we spot as concerns.

Mr. LAMPHRON. Sure

Mr. WALDEN. Concerns enough that we put them year after year on our internal documents.

Mr. LAMPHRON. Yes.

Mr. WALDEN. Meanwhile we put that it is great controls, everything is in place.

Mr. LAMPHRON. Right.

Mr. WALDEN. There is no way you can have a misstatement of financial.

Mr. LAMPHRON. Well, if their internal audit department was charged with doing financial audits, and—

Mr. WALDEN. Which they did.

Mr. LAMPHRON. And in our assessment we found them to be incompetent or not well trained, or not well supervised, we would bring—we would talk to the audit committee. Because by having internal audit focus that way, they would be expecting that in the design of our audit we would place reliance on the work internal audit does. That was not an issue.

Again, they choose to use them over here. All it meant was we had to use more of our people and take more time in doing the audit.

With respect—you indicated that we viewed management as being aggressive.

Mr. WALDEN. Yes.

Mr. LAMPHRON. I need to sort of clarify that. I think we viewed the Chairman as being a dominant personality, aggressive person. We did not view management way.

I can tell you that from 2000 forward when I was engagement partner and had meetings with the CFO, with the controller to discuss accounting issues, every time that I can think of they said what do you think, how should this be accounted for. We told them, and they said okay, that is what we will do. We want to do the right thing.

Now, certainly there is some irony there after all we have come to learn.

Mr. WALDEN. Sure.

Mr. LAMPHRON. But that was their persona. That was the picture they put up in front of us. They were not aggressive. They were not—they were not pushing the accounting envelop.

Mr. WALDEN. They were not cavalier?

Mr. LAMPHRON. Again and again they said we want to do the right thing. You tell us what that is and—

Mr. WALDEN. All right. But in your 1999, I guess, proceeding, you are in charge of this, both yes and no are checked when it says “Management displays a cavalier attitude toward an inadequate monitoring of significant business risks.” “Management’s excess interest to maintain or increasing client stock price earnings trend” is checked yes. “Management dominated by one or a few individuals without effective oversight by the Board of Directors or audit committee.”

Those are not flags that should—that you share with an audit committee? None of those rise to the level? They rose to somebody’s level to check them here.

Mr. LAMPHRON. Well, again, having a focus on earnings for a public company is normal. We did not—

Mr. WALDEN. But that is not what you say. I mean, it is management's excessive interest.

Mr. LAMPHRON. Well, that is the way the checklist is worded and, you know, we do not have the ability to modify it. But I can tell you the intent in the years I was responsible for it when we checked that, it is a reminder. That is what this whole checklist is, it is a reminder. And we say, sure, they are a public company. These guys are focused on earnings. Let us keep that in mind as we do our audit, as we plan our audit, as we conduct our procedures. And that is what we did.

Mr. WALDEN. Looking back, and I realize that it is a lot easier to see looking back, when I read this checklist and see a pretty clear picture that a company is driven by a very strong executive who lacks oversight by the Board and audit committee who is consumed with earnings numbers in an area where there is cavalier attitude toward business risks—I mean I look at what you all did and say that it was like you were pointing but you did not know when to pull the trigger. Because you were seeing all the indicators, but somehow it got passed you.

Mr. GREENWOOD. The time of the gentleman has expired.

Mr. LAMPHRON. Congressman Walden, I would concede that looking back you can certainly take a different view of these things. But at the time onsite—

Mr. WALDEN. You did not see it?

Mr. LAMPHRON. [continuing] they were not red flags. They were not red flags at us. Sorry.

Mr. WALDEN. Thank you, Mr. Chairman.

Mr. GREENWOOD. The gentleman from Florida, Mr. Stearns recognized for 10 minutes.

Mr. STEARNS. Thank you, Mr. Chairman.

We all up here have the benefit of hindsight, you know. So we are able to ask these questions that, you know, in the overall operations day-to-day for us seem significant, but perhaps for you it was not. And one I want to talk about is the Tab 72, which is the letter from a "fleeced shareholders" to Ernst & Young and HealthSouth. You probably heard us talk about this when we were talking to the Board of Directors.

Mr. LAMPHRON. Yes, sir.

Mr. STEARNS. They could say that this letter, anonymous letter that came from a "fleeced shareholder" in November 12, 1998, so that was 5 years ago, talked all in detail about some of the problems with HealthSouth. So the letter, evidently, went to you folks and I guess it is to Mr. Dandurand.

Mr. DANDURAND. Yes.

Mr. STEARNS. Were you involved with the account, the HealthSouth account when the "fleeced shareholder" facts came in to your company?

Mr. DANDURAND. Yes, Congressman.

Mr. STEARNS. Okay. Now, you saw a copy of the letter yourself?

Mr. DANDURAND. Oh, yes.

Mr. STEARNS. Okay. Okay. And would you not agree with me, somebody who wrote this letter had to have a pretty good idea of what was the problems? I mean, they talked about the impact of Tefra reimbursements. They talked about the balanced budget

amendment, and the cutbacks and the Medicare. They talked about how the Ernst & Young auditors in Alabama missed things. I mean, it seemed if I got this memo, it would sort of put some antenna up.

Now, I know you folks are busy. So my question is did you folks address the allegations that are in this letter from 5 years ago, and what did you do?

Mr. DANDURAND. Yes, Congressman.

Mr. STEARNS. Sure.

Mr. DANDURAND. We took this very, very seriously. We do not get these kinds of letters very often.

Mr. STEARNS. Especially with this kind of detail.

Mr. DANDURAND. And, unfortunately, it was anonymous. And it is in detail.

We took two actions related to the receipt of this letter. And, as you can see, this letter came to the Chairman of our firm. It went to the SEC. It went to HCFA.

Mr. STEARNS. It went to the SEC?

Mr. DANDURAND. Yes. HCFA, the American Institute of Certified Public Accountants.

Mr. STEARNS. Did the SEC respond to this?

Mr. DANDURAND. I am not aware they ever did.

Mr. STEARNS. They never called you and said, look what is the story on this letter? You better get hopping on it or anything.

Mr. DANDURAND. I know they did not do that.

Mr. STEARNS. They did not? Okay.

Mr. DANDURAND. That is correct.

But what we did, we took two actions really as a result of this letter.

Mr. STEARNS. Yes.

Mr. DANDURAND. We took a similar action that was described earlier, in that we notified the company that we had received this letter—

Mr. STEARNS. When you notified the company, was Mr. Scrusby aware of these allegations? Did he get told?

Mr. DANDURAND. I believe he did. In fact, I have been told and I am positive, I feel very comfortable that he was aware of these allegations. Yes.

Mr. STEARNS. When I look at the memo it has, you know as you mentioned, Morgan Stanley. It was cc'd to a lot of people. We do not know, in fact, whether they got it at all. But at least the memo said it was sent to them, so we just have to speculate. We assume they got it, but we have never confirmed it. But you have never got anything back from any of these people on the cc saying we got this memo, what is the story?

Mr. DANDURAND. That is correct, Congressman.

Mr. STEARNS. Okay.

Mr. DANDURAND. We know we got ours.

Mr. STEARNS. All right. Yes. Okay. So you think you have a pretty sure, what? Ninety percent sure that Mr. Scrusby was aware of the allegations?

Mr. DANDURAND. Yes, I am.

Mr. STEARNS. A 100 percent?

Mr. DANDURAND. It is 5 years ago.

Mr. STEARNS. Yes, you do not know. I know.

Mr. DANDURAND. And I am under oath. I just, you know—

Mr. STEARNS. Okay.

Mr. DANDURAND. [continuing] feel uncomfortable saying 100 percent.

Mr. STEARNS. All right. So the question is—

Mr. DANDURAND. I will say 95, 90, whatever.

Mr. STEARNS. Right. And so Mr. Scrusby knows about it. You folks know about it. And do you think the Board of Directors knew about it?

Mr. DANDURAND. No, I do not.

Mr. STEARNS. You do not think so? And did you ever tell the Board of Directors?

Mr. DANDURAND. No, and I would like to explain that, if I could.

Mr. STEARNS. Yes. Yes.

Mr. DANDURAND. Because I think it is important to understand the actions that we did take.

We took two actions, as I mentioned earlier. The first was to notify the company in accordance with our professional standards to let them know that we had received this letter. And in that context, I called Michael Martin, who was the chief financial officer at the time, and told him that I wanted to come share this letter with him, which I did that same afternoon.

I met with—

Mr. STEARNS. I think that is very good.

Mr. DANDURAND. I met with Mr. Martin and Mr. Owens at the time, who was the controller of the company. I shared the letter with them. And then the discussion started as to how the letter should be responded to.

My initial recommendation was the company ought to consider hiring an independent counsel to investigate this and report back. Mr. Martin and Mr. Owens felt that maybe at this time it was premature, which certainly was their prerogative, and in that context I suggested then that it needs to be—should be audited or reviewed by someone independent of the financial folks. And suggested Mr. Horton, who is the general counsel, might be the appropriate person or certainly someone might consider that.

Mr. STEARNS. Do you know if Mr. Horton got the memo and did anything?

Mr. DANDURAND. Oh, I he got the memo because—

Mr. STEARNS. So you are 100 percent sure he got the memo, but you are not sure what he did?

Mr. DANDURAND. Well, I will try and explain—

Mr. STEARNS. Okay.

Mr. DANDURAND. [continuing] exactly what I remember of the whole situation.

So at that point Mr. Horton was called and invited to Mr. Martin's office.

Mr. STEARNS. Yes.

Mr. DANDURAND. And certainly the letter was shared with him. There was some discussion about how the review ought to proceed. My recommendation, again, was to again keep it independent. I suggested that Teresa Sanders, who was the—

Mr. STEARNS. When you say "independent," you mean outside the company?

Mr. DANDURAND. Outside of the area where the allegations were being directed.

Mr. STEARNS. Which should be the right way to do it, sure.

Mr. DANDURAND. I would think so.

Mr. STEARNS. Yes.

Mr. DANDURAND. At least thought so at the time.

Mr. STEARNS. Right.

Mr. DANDURAND. And that—and then I offered Ernst & Young's help in that capacity.

Mr. STEARNS. Was any report resulting from this independent—was an independent counsel selected?

Mr. DANDURAND. No, it was not. General counsel—

Mr. STEARNS. Nothing was done then? General counsel did it?

Mr. DANDURAND. No, general counsel did.

Mr. STEARNS. Did you see the report from the general counsel?

Mr. DANDURAND. Well, I had several conversations with him and followed up verbally.

But the point I would like to make in addition to that action, is that Ernst & Young took our own independent action related to those charges. The—

Mr. STEARNS. So you invested the "fleece" memo yourself?

Mr. DANDURAND. Well, not only did I do it, but the firm sent two of our associates from the PPD office over to independently look at our work.

Mr. STEARNS. You actually met with the audit committee at HealthSouth and gave it to them, and told them about it?

Mr. DANDURAND. No, we did not.

Mr. STEARNS. No? Okay.

Mr. DANDURAND. We did an independent review. And if you read the letter—

Mr. STEARNS. Because, Mr. Horton you gave it him, you suggested outside counsel?

Mr. DANDURAND. Yes.

Mr. STEARNS. He did not go ahead with it. So at this point you left it in his responsibility and then you acted independently on your own?

Mr. DANDURAND. That is correct. But I would like to go back to that, because there is I think one more important element that you reminded me of; is that I did suggest that the company inform Dr. Watkins, who at that time was Chairman of the audit committee. And they told me that they would about receiving the letter.

Mr. STEARNS. So under that scenario, the Board of Directors was told about it?

Mr. DANDURAND. Well—

Mr. STEARNS. Hearsay? From your—

Mr. DANDURAND. I had a lot of confidence in Mr. Horton and assumed that that took place. I do not know what—

Mr. STEARNS. So your inner feelings was I have done the right thing. I have given it to the counsel. I have made a recommendation. But Ernst & Young never went back and took each allegation and investigated it down into detail?

Mr. DANDURAND. No, that is not correct. And I would like to make myself clear on that.

Mr. STEARNS. I got another whole area I want to explore. So I am sorry, I do not mean to do this.

Mr. DANDURAND. We certainly did. The firm sent 2 representatives over to look at our work papers, to talk to our engagement team, to go down each and every charge in that letter. And to—

Mr. STEARNS. And were they all considered false or correct?

Mr. DANDURAND. Well, I—

Mr. STEARNS. I mean, for example, did the Ernst & Young auditors in Alabama miss things that the “fleece” letter says? Just yes or no.

Mr. DANDURAND. I say no.

Mr. STEARNS. Okay. What about the idea that, this is an accounting question, how can the company carry tens of millions of dollars in accounts receivable that are well over 360 days? Is that normal.

Mr. DANDURAND. Well, in a company of this size—

Mr. STEARNS. It is, yes.

Mr. DANDURAND. [continuing] and I remind you it is over a billion dollars a healthcare company, yes.

Mr. STEARNS. So when they say the accounting slick, the cost reports are not accurate, so your opinion is this memo is false and this memo is incorrect and you corroborated through your investigation that this has no validity; that is your statement today?

Mr. DANDURAND. My statement is we concluded that—

Mr. STEARNS. Had no validity?

Mr. DANDURAND. [continuing] it had no impact on the financial statements.

Mr. STEARNS. Okay. So I would say we can pretty much say from Ernst & Young’s standpoint this memo had no validity?

Mr. DANDURAND. We did not believe the charges—

Mr. STEARNS. Did you go back to Mr. Horton and tell him look, we have looked at this and this doesn’t mean anything?

Mr. DANDURAND. I do not remember having that conversation.

Mr. STEARNS. Okay.

Mr. DANDURAND. I also would like to point out that we did provide the staff with a detailed description of our procedures in case I forgot something here.

Mr. STEARNS. Yes. Okay. Let me just turn quickly to the pristine audits. And you probably heard my conversation with the Board of Directors on this. You know “The Wall Street Journal” did an article on this, and if you like you can probably to Tab 89. It talked about, you know, this pristine audits that you performed. You had junior level executives go into HealthSouth and armed with a 50 point checklist to reevaluate things; whether toilets were free of stains, trash receptacles had liners. And so did Ernst & Young in fact advise HealthSouth to classify pristine audits as audit related services? Because I have here this audit fees for proxy disclosure, and you have the audit fees and then you have audit fees related. And that, evidently, is what you put the pristine audits.

So the question I have you, did you classify these pristine audits when you were actually looking at whether toilets were free of stains and trash receptacles had liners, was that a separate audit related fee on the accounting statement?

Mr. DANDURAND. Congressman, I believe those standards for the description of audit related—

Mr. STEARNS. Are normal?

Mr. DANDURAND. Came into being after I retired. So I am not comfortable knowing what those figures are.

Mr. STEARNS. But you folks did this?

Mr. LAMPHRON. That classification was done for the 2001/2000.

Mr. STEARNS. Yes. And I guess the question—

Mr. LAMPHRON. When I was the engagement partner.

Mr. STEARNS. Yes. I am sorry. Mr. Lamphron, you were the one I probably should address this question. I am sorry.

Okay. This was done, and it was done this way. Now in a “Wall Street” article it was brought out that this was done, and low and beyond, I guess the SEC sent you folks a letter on July 8, 2003 about it. Do you remember this letter?

Mr. LAMPHRON. I think I have seen a copy of it.

Mr. STEARNS. It sort of said that what you did in classifying these pristine audits of checking the toilets and things would not be correct today. Let me just read from the letter, and if you do not have it, I can give it to you.

“The Commission current rule states that registrants are to disclose under the caption audit related fees, the aggregate fees billed in each of the last 2 fiscal years for assurance and related service by the principal accountant that are reasonably related to the performance of the audit review or the registrant’s financial statement.”

So they are saying that you were wrong to put it into the audit related fees and that classification is incorrect.

Mr. LAMPHRON. I do not think they were saying we were wrong at the time. I think that the letter says that under the new rules they would not be classified as audit related, and we agree completely.

Mr. STEARNS. The article quotes the SEC former chief accountant Lynn Turner as saying “Ernst & Young arguing that checking the cleanliness of a facility is audit related goes well beyond the pale of sanity and common sense.”

On a common sense level does it make sense for you to classify this as audit related?

Mr. LAMPHRON. Under the—

Mr. STEARNS. I mean in retrospect. I am sorry.

Mr. LAMPHRON. Under the existing rules there were three classifications. Audit, which deals with just the corporate audit and the quarterly reviews; information technology work and other. We classified it in other.

We went further and put a subcategory that was not required or defined at the time of audit related because they were operational audits.

Mr. STEARNS. Today would you classify it the same way?

Mr. LAMPHRON. No. There is guidance that makes it very clear we would not put it in that category.

Mr. STEARNS. I think you would not be off base to say you did it wrong. I mean, you seem to be hedging a bit, but it seems to me that you are saying you would not do it this way today.

Mr. LAMPHRON. I am not hedging. I am saying that at the time with no guidance on what would go in audit related, that we considered these operational audits and as such, we put them in audit related.

Mr. STEARNS. Okay. But the SEC former chief account Lynn Turner disagrees with you.

Mr. GREENWOOD. The time of the gentleman has expired.

Mr. STEARNS. Yes. Thanks.

Mr. GREENWOOD. The gentleman from New Jersey, Mr. Ferguson is recognized for 10 minutes.

Mr. FERGUSON. Thank you, Mr. Chairman.

Mr. Lamphron, I am over here.

You have been going for a while. Do you want to take a sip of water or something.

Mr. LAMPHRON. I am okay. Thank you.

Mr. FERGUSON. I do not know if you saw the last hearing, our first hearing on this.

Mr. LAMPHRON. I did.

Mr. FERGUSON. The last hearing we heard a lot about internal controls at HealthSouth. Can you tell some of the nonaccountants here a little bit about internal controls. What do we mean when we say internal control?

Mr. LAMPHRON. Let me give you an example. A very classic example would be where a business has a policy where checks above a certain amount have to be signed by two people instead of just one. That's—the basis of that is just human nature, knowing that it is easier for a crime to be committed by one person than it is by two people who to do that have to engage in collusive activities.

Mr. FERGUSON. So having a check signed by two people or limiting people who can authorize certain transactions, those are examples of internal controls?

Mr. LAMPHRON. Sure.

Mr. FERGUSON. What are some examples of internal controls that were in place at HealthSouth?

Mr. LAMPHRON. Well, one that comes to mind deals with their cash. They had a treasury group that monitored cash balances on all 2600 accounts on a daily basis. Now, all the activity that affected the financial statements recording cash disbursements, cash receipts was done in the general accounting department. So the control was you had this group in treasury separate and distinct that overlooked that and made comparisons and that sort of thing.

Mr. FERGUSON. Are publicly traded companies required by law to have internal control?

Mr. LAMPHRON. Yes, absolutely. The Fair Practices Act requires that.

Mr. FERGUSON. And who is responsible for maintaining this system of internal controls at a publicly traded company?

Mr. LAMPHRON. Well, I think it extends to senior management all the way through the CEO, but from a practical standpoint it is typically the CFO who has that—who deals with those sorts of things.

Mr. FERGUSON. What about the auditors? Do the auditors have a role in maintaining the internal controls at a company, the outside auditors?

Mr. LAMPHRON. Well, we review internal controls as part of every audit. If we saw weaknesses, we would communicate those to management, to the audit committee.

Mr. FERGUSON. How is Sarbanes-Oxley effecting that?

Mr. LAMPHRON. Well, significantly, I think. One provision I am thinking of is 404 of Sarbanes-Oxley which requires management to attest—to evaluate and to test to those internal controls. And then for us to audit management's attestation.

Mr. FERGUSON. If management is in intent on circumventing internal controls to commit fraud, is there something that the auditors can do about that?

Mr. LAMPHRON. No. I think we heard from numerous people, it is very clear in our professional literature that collusive fraud may be impossible to detect.

HealthSouth had a—on paper HealthSouth had a formidable system of internal controls. They were doing all the right things. We heard from Mr. Wallance this morning about best practices and corporate governance. And we were sitting in there thinking they did all those things. They had policies, procedures in place.

Now, obviously, what we did not know was there was a large group of criminals sort of behind the scene that were overriding those controls. And there is no system that is going to prevent that.

Mr. FERGUSON. So is that your opinion of what happened here? That they could have had the best system of internal controls in the world, but if you had management intent on doing an end run around those internal controls, it undermines the effectiveness of those internal controls?

Mr. LAMPHRON. That is correct.

Mr. FERGUSON. Is that your opinion?

Mr. LAMPHRON. Yes, sir.

Mr. FERGUSON. Okay. Let me return to a line of questioning that I had pursued in the first hearing. You said you had seen, you had watched the first hearing.

Specifically in some questions I asked Ms. Henze because when she was—and I asked her some questions about what she did when she realized or found out that there was fraud being committed or when she suspected there was fraud going on. And when she confronted Mr. Owens and he did not deny the fraud, do you recall that from her testimony?

Mr. LAMPHRON. Yes, sir.

Mr. FERGUSON. Ms. Henze was known to your audit team?

Mr. LAMPHRON. She was known very well to us. In fact, for several years she was the primary audit coordinator.

Mr. FERGUSON. How often did Ernst & Young talk with her?

Mr. LAMPHRON. Daily, every other day.

Mr. FERGUSON. Regularly?

Mr. LAMPHRON. During the course of the audit, yes.

Mr. FERGUSON. Did she ever tell anybody on the audit team about the fraud that she had uncovered or suspected?

Mr. LAMPHRON. Never once.

Mr. FERGUSON. Okay. That is what she said as well.

Did she report her concerns—she did report her concerns of fraud internally, though. She talked with some folks at the compliance department, Kelly Cullison in particular. Is that correct?

Mr. LAMPHRON. That is correct.

Mr. FERGUSON. And Ms. Cullison testified that she confirmed that these fraudulent adjustments had been described to her by Ms. Henze and that they in fact had been made. She then referred the entire matter to her boss, Mr. Tanner. Correct?

Mr. LAMPHRON. That is correct.

Mr. FERGUSON. Who was one of the founders of the company. He was serving as the head of compliance.

Mr. LAMPHRON. Right.

Mr. FERGUSON. That is right?

Mr. LAMPHRON. Yes.

Mr. FERGUSON. Was Ms. Cullison known to your audit team?

Mr. LAMPHRON. Yes. As a matter of fact, a routine part of each audit we would ask her in her role as—in the compliance department about the nature of the complaints and issues. In fact, I got to tell you, I listened to the testimony a couple of weeks ago and I cannot tell you how frustrated I was. And let me tell you why.

Subsequent to Henze going to Cullison and Cullison going to Tanner, we sat down and met with them face-to-face. There were two Ernst & Young partners and another person there. We asked them, tell us about activities in the compliance department. Tell us about anything that has come to your attention, whether resolved or whatever the status. Tell us anything that might have any effect on the financial statements. And they looked us in the eye and lied to us.

Mr. FERGUSON. You made an actual inquiry of Ms. Cullison?

Mr. LAMPHRON. That is correct.

Mr. FERGUSON. A direct inquiry?

Mr. LAMPHRON. That is correct.

Mr. FERGUSON. Okay.

Mr. DANDURAND. Can I respond, because I was the one that made that inquiry?

Mr. FERGUSON. Sure.

Mr. DANDURAND. And it is very important to me that everyone understand that 6 feet away from me was the answer to everything that was going on. And we asked the right question, and we still did not get the right answer.

Mr. FERGUSON. So Mr. Tanner, he was not able to recall much about his final years at HealthSouth. But you are saying that your audit team at Ernst & Young, you made an actual inquiry, affirmative inquiry of Ms. Cullison and Mr. Tanner?

Mr. LAMPHRON. Yes, and I would add Mr. Hale was at the meeting. But he was due to take over the department. So our questions were to Tanner and Cullison.

Mr. FERGUSON. And you asked them if any allegations of fraud had been made or brought up?

Mr. LAMPHRON. We asked them exactly that.

Mr. FERGUSON. And did you ask the compliance officials what complaints they had perhaps received or substantiated?

Mr. LAMPHRON. We asked them to describe the nature of those. And I believe as we have it documented, the description is that fairly routine personnel type issues that they were able to push off to people in human resources.

Mr. FERGUSON. So Ms. Henze brought her concerns to Ms. Cullison. Ms. Cullison brought her concerns to Mr. Tanner. You and your team directly asked Mr. Tanner and Ms. Cullison about any allegations or suspicion of fraud. And they told you there was none?

Mr. LAMPHRON. Yes.

Mr. FERGUSON. And this is all in connection with the 1999 audit?

Mr. LAMPHRON. That is correct. In fact, the meeting was on December 3, 1999.

Mr. FERGUSON. Okay. And at that meeting did Ms. Cullison say anything about what Ms. Henze had come to her about?

Mr. LAMPHRON. Absolutely not.

Mr. FERGUSON. Okay.

Mr. LAMPHRON. No hint, no wink, no reference, nothing.

Mr. FERGUSON. Okay. So, I just want to get this straight. You asked them a straight question, they were mum with regard to the 1999 audit?

Is it your opinion that—I mean, it just seems to me a lot of this could have been avoided if they had spoken up at that time.

Mr. LAMPHRON. Absolutely. And even outside of that meeting with respect to Henze, I mean, we probably met with her 50 or 100 times during the audit process for several years. She just had multiple opportunities to just say one thing to us. She did not take that opportunity.

Mr. FERGUSON. This meeting that you are talking about, is it documented?

Mr. LAMPHRON. Yes, sir.

Mr. FERGUSON. Where?

Mr. LAMPHRON. In our work papers, and I think we have provided that to your staff. I am not certain, but we can certainly get it for you.

Mr. FERGUSON. That is all I have, Mr. Chairman. Thank you. I yield back.

Mr. GREENWOOD. The Chair thanks the gentleman.

The Chair recognizes himself for 5 minutes.

A cynic connecting the dots after the fact might think something like this: According to the indictment the fraudulent activity began around 1996. In 1995 there is a report from the Center For Financial Research and Analysis that says—there is a lot of red flag, or at least pink flags or some things to worry about with this company.

In 1996 right after Mr. Scrusby allegedly started cooking the books, he decides out of the clear blue sky to make—basically double the amount of money he is paying to his auditors. Makes up kind of this cockamamie pristine audit business. You get the “fleeced stockholder” piece in 1998. You get the email in 2002. Connecting the dots from where we sit today, it makes us fairly suspicious.

Mr. Dandurand, you said that in response to the issue about the “fleeced shareholder” letter that you do not get letters like that very often.

Is it common for an auditing firm to have a client with this sort of number of things happening where you get these allegations coming in, is that routine or is this extraordinary to have allega-

tions of this specificity and this seriousness come in with regard to a client? Anyway?

Mr. DANDURAND. Go ahead.

Mr. LAMPHRON. Well, you know, first I would remind you that with respect to the "fleeced shareholder" letter and the Vines' email, that is 5 years between those. So it is not like we sat there and these things were tumbling down on us. But we were aware of those.

Mr. GREENWOOD. Yes.

Mr. LAMPHRON. But, you know, we took——

Mr. GREENWOOD. You have already very well explained.

Mr. LAMPHRON. [continuing] those and investigated them.

Mr. GREENWOOD. Yes. And you have already explained it. I am not questioning.

Mr. LAMPHRON. Yes.

Mr. GREENWOOD. I am just trying to get to a specific point, which is is this unusual? Do you have other clients where you have had two, even 5 years apart, two hand grenades hurled over the transom like this?

Mr. LAMPHRON. Not that I can recall right now, Mr. Chairman.

Mr. GREENWOOD. Okay. Ms. Givens said in her 13 years on the Board, Ernst & Young never brought a single problem to their attention. Is that true? The Board's attention, never brought a single concern?

Mr. LAMPHRON. I cannot speak to the entire 13 years, but I can say that, you know, I know we talked to her about proposed audit adjustments where we felt balances should be different than what we recorded. You might call that an issue.

You know, beyond or before 2000, I just do not know.

Mr. GREENWOOD. Okay. What about this policy that, Mr. Lamphron, you said that the standard operating procedures is if something comes in, a compliant like this comes in from the outside, that you go over to a person in superior position to that person to bring it to their attention? It seems to me that it is not the little guys that have a whole lot at stake in managing earnings and falsifying books. It is the big dogs at the top that have the stock options and a whole lot to gain in bonuses and all of the rest if earnings are fraudulently managed. And I am not attributing that to you. You are following the standard operating procedures. But help us out here. Does that make sense?

It seems to me that in each of these cases that we have seen over the last several years, it is the guys at the top that are gaming the system. It is the guys at the bottom that frequently have the best insight into what is going wrong with the company.

Mr. LAMPHRON. Well, again, I followed all of our internal——

Mr. GREENWOOD. No, I know you did. And I am not faulting you. You think it is a good idea? Do you understand the concern that I might have?

Mr. LAMPHRON. I do. And I would respond by saying we went to the Chairman of the audit committee. Now, it does not go much higher.

Mr. GREENWOOD. Okay. Mr. Dandurand, you had told us earlier that you made an inquiry of Mr. Tanner and Cullison about wheth-

er any allegation of fraud were made. Did you review the compliance, the log complaints for fraud?

Mr. DANDURAND. I did not, Mr. Chairman.

Mr. GREENWOOD. Okay. Was that ever part of your audit procedure to do that?

Mr. DANDURAND. We did not, to my knowledge.

Mr. GREENWOOD. You can do a sampling of the complaints that came in on the log?

Mr. DANDURAND. No, we do not. I have a lot of confidence in both Mr. Tanner and Ms. Cullison, and the entire corporate compliance program that was put into place.

Mr. GREENWOOD. You took their word for it that—

Mr. DANDURAND. Unfortunately, I did.

Mr. GREENWOOD. Okay. You would not do that again if you had it to do over again?

Mr. DANDURAND. Well, I do not know what I would do—

Mr. GREENWOOD. Final question. When was the pristine audit program started?

Mr. DANDURAND. I believe in 1996.

Mr. GREENWOOD. Okay. And in retrospect, and I am not casting the tiniest dispersion on Ernst & Young when I say this, in retrospect when you see an indictment that says that the fraud began in 1996 do you wonder whether Mr. Scrushy said to himself I am about to start cooking some serious books here and I have an auditing company that might find out about this, let me invent a lovely sweetener of the pot? Has that thought occurred to you?

Mr. DANDURAND. It never has. And, Mr. Chairman, HealthSouth is not a significant client to Ernst & Young. Never has been.

Mr. GREENWOOD. Okay. Fair enough.

What percentage of your income was HealthSouth?

Mr. DANDURAND. Oh, that is difficult.

Mr. GREENWOOD. In the Birmingham office?

Mr. DANDURAND. I have been retired. Well, we do not measure particularly Birmingham office, per se.

Mr. GREENWOOD. Anybody else know what percentage it is in Birmingham?

Mr. DANDURAND. You may have the information related to that. I have seen percentages calculated, and I do not agree with the way they were calculated.

Mr. GREENWOOD. Anybody else?

Mr. LAMPHRON. We manage our practice on an area basis. And it was no more than one to one and half percent in any year.

Mr. GREENWOOD. Okay. We seem to have some documents that says it was 15 percent.

Mr. DANDURAND. I have seen those documents. And I disagree with how that was calculated. That basically adds up the pristine audit revenues and puts them in the Birmingham office, whereas all that work was done throughout the entire firm and was not done in the Birmingham office. So although—

Mr. GREENWOOD. Did Ernst & Young make more profit on the financial audits or on the pristine audits?

Mr. DANDURAND. Oh, I do not remember.

Mr. LAMPHRON. I do not know. But this questioning raises the issue of can we be—is were we influenced by that.

Mr. GREENWOOD. And I am not raising that question. I am trying to find out whether Mr. Scrushy, that might have been his intention.

Mr. LAMPHRON. Well, just to put in perspective. Again, 1 to 1.5 percent on an area basis, firm wide less than I think .1 of 1 percent. But I would just repeat what we hear almost every week, and certainly our new people that start, they hear it probably the first day. There is no client too important to cause us to jeopardize their professional reputation.

Mr. GREENWOOD. Glad to hear that.

Mr. LAMPHRON. It did not influence me, and it did not influence this team.

Mr. GREENWOOD. I believe you.

The gentelady from Colorado is recognized for 5 minutes.

Ms. DEGETTE. Thank you, Mr. Chairman.

I wanted to follow up on my question to you, Mr. Lamphron, about whether you made more fees on the pristine audits or on the audit fees. And you unequivocally said no.

Mr. LAMPHRON. Right.

Ms. DEGETTE. So I went back to where I was confused, because I had been reading the proxy disclosure for 2000 year end, and if you want to look at Tab 85, you know what I am talking about?

Mr. LAMPHRON. Yes.

Ms. DEGETTE. Because what it says in the proxy disclosure which was filed with the SEC, it says audit fees, total audit fees for 2000, \$1,026,649. And for that same year then, at least on this proxy disclosure, it says pristine audits \$1,250,000 which is more, correct?

Mr. LAMPHRON. Let me explain my statement. Is that what you would like me to do?

Ms. DEGETTE. And then for 2001 same thing it is \$1,165,750 for total audit fees and then \$1,332,261 for pristine audits. You would not disagree that is what this proxy disclosure says, correct?

Mr. LAMPHRON. That is what the proxy disclosure says.

Ms. DEGETTE. Okay. So why do you not tell me what you meant?

Mr. LAMPHRON. Well, at the time—the proxy rules have changed. But at the time in 2000/2001 the definition of audit fees was very narrow. It was the audit of the consolidated financial statements and the quarterly reviews. In addition to that, each and every year we did a number of other audits.

Ms. DEGETTE. Right. Which are in also in the proxy.

Mr. LAMPHRON. Thirteen, 14, sometimes 15 or more audits.

Ms. DEGETTE. Right.

Mr. LAMPHRON. The question was did our audit fees, were our audit fees less. Our audit fees were not. You add all the audit fees together and exceeded what we received on the pristine audit.

Ms. DEGETTE. Right. But my question to you was based on what was filed at the SEC, which says the total audit fees were less than the pristine audit. I just wanted to clear the record up. You know, I think we are talking about apples and oranges.

One last question, which is the same question I asked to the last panel. Like the Chairman, I would never impugn your integrity or your motives. But I must say, I do have a concern when you have a firm that has been engaged to perform an independent audit,

when you have a CEO who was indicted yesterday on 85 counts of fraud. And as we discussed earlier, a pretty basic textbook kind of fraud, for the most part. Fifteen senior executives including 5 CFOs have plead guilty to criminal offenses. And you folks were the external auditors.

I have heard today you had conversations with people, you talked to folks, you asked the company for some records which they supplied you when allegations were made.

Hindsight is 20/20, but in conducting an independent audit today, is there more you could do to stop this kind of widespread fraud, which of course hurts all the employees of HealthSouth plus the stockholders? Any of you.

Mr. LAMPHRON. Well, again, if there—regardless of how well the system of internal controls is developed, if there is widespread collusive fraud, it may not be detected. But—

Ms. DEGETTE. So your answer is no? You do not think there is anything else that could be done to avoid this?

Mr. LAMPHRON. Well, I was going to go on and say that there are a number of things that have happened since then that have—we have got a new auditing standard, for instance, which basically increases our attention we pay to the potential for fraud. We heightened the awareness on the engagement team. We spent 300,000 hours in Ernst & Young educating our people on fraud awareness.

I mean, there is a lot of things we have done. And we would hope we would detect fraud, but again if we are examining a transaction and we ask senior management, financial management and then we go and ask the people in general accounting, and if we ask legal counsel, and if we ask treasury, and we if we ask tax and they all give us the same answer—

Ms. DEGETTE. Yes.

Mr. LAMPHRON. [continuing] and the same documents, you will never uncover it.

Ms. DEGETTE. You know what it depends on, and you know this and I know this, we all know this. It does not depend on what those people say. It depends on what the records show, right? And I think the thing to do is next time go in and get the supporting documentation. If that had happened, for example, with the allegations that were made in this case, you would have caught it right away. Do you not think so?

Mr. LAMPHRON. Possibly, but the implication that we do not check documentation is, you know—we—to the extent there is documentation, we look for it. We do not audit by conversation.

Ms. DEGETTE. Thank you.

Mr. LAMPHRON. What we know at this point is that they falsified documents.

Ms. DEGETTE. Well, okay. Thank you very much.

Mr. GREENWOOD. The gentleman from Florida for 5 minutes.

Mr. STEARNS. Mr. Chairman, thank you.

Just sort of a summary comment here. I have here the indictment of the United States of America versus Richard Scrushy, the defendant. And I am reading on page 11 about the overall acts. And it is staggering how much money that we are talking about. It said from 1996 to the year 2003 Richard Scrushy and others reviewed internal financial statements setting forth the actual finan-

cial condition. And from that same period of time, with coconspirators, senior officers they falsified record.

Then it says coconspirators including members of the corporate accounting staff made and caused to be made entries in the books and records of HealthSouth which causes the following approximate amount of fictitious income to be included in the annual report to stockholders and SEC filings for the year 1996 through 2001 and intended to be included in the annual report to stockholders and SEC filings for the year 2002.

Let me just read the amounts, and I know you know them. And this is all alleged now. But, I mean, this is staggering.

Amount of fictitious income in 1996 was \$70 million. 1997 \$70 million. 1998 550 million. 1999 \$390 million. 2000 \$350 million. 2001 \$450 million. And 2002 \$230 million. For a total, grand total of \$2.740 billion dollars, fictitious fraudulent income.

That does not include what the coconspirators of the corporate accounting staff added to that. And they have \$370 million in cash. Approximately \$27 million in the stock of a publicly traded company.

And so, I mean, when you look at the amount of money that was fictitious and fraudulently—it does not happen in 1 year. It happens in 1, 2, 3, 4, 5, 6, 7 years. And that must be, in all honestly just between you and I, staggering to you as the accounting firm of record for this kind of fictitious income under your watch. And I have to point that out, that it is hard to believe that that all amount could—I mean, this is not \$10 or \$100, this is billions of dollars.

So, you know, I will certainly give you an opportunity to comment on that. That is just my closing comment. It is probably very difficult for you to do, because this is alleged by the Department of Justice.

Mr. LAMPHRON. There is no doubt it is staggering, shocking. Again, we share your outrage with this whole thing. You know, we had what we thought was a very prosperous, very fast growing organization, the pride of Birmingham. And if you look at those numbers, which last night was the first time I had a chance to look at them, what you see is they were basically not making any money and often had losses.

Mr. STEARNS. And, you know, sometimes of the tip of the iceberg is nine-tenths below the water. So this is what the Justice Department finds, \$2.74 billion. It could be much more. So, let us hope not for the stockholders and shareholders. But that is my only comment.

Mr. Chairman, I return the balance of my time.

Mr. GREENWOOD. The Chair thanks the gentleman.

The Chair thanks the members of the panel, the witnesses. Thank you for your testimony. We appreciate it. And you are now excused.

Mr. LAMPHRON. Thank you.

Mr. GREENWOOD. And the Chair would call forward our fourth and final panel consisting of: Mr. Howard Capek, former Managing Director of UBS Warburg Equity Research and Healthcare Group; Mr. Benjamin Lorello, head of Global Healthcare Finance Group at UBS Warburg; Mr. William McGahan, former co-head of Global

Healthcare Finance Group at UBS Warburg; Mr. Lanny Davis, formerly of Patton Boggs, former counsel to HealthSouth and Richard Scrushy, and; Mr. Hal Hirsch, formerly of Fulbright & Jaworski, former counsel to HealthSouth.

Gentlemen, we welcome you. We thank you for your patience.

As you may have heard me say to the other panels, the other witnesses, that it is the practice of the Oversight and Investigation subcommittee to take testimony under oath. And I need to ask if any of you object to giving your testimony under oath. I see no such objection.

I also, pursuant to the rules of the House and this committee, need to advise you that you are entitled to be represented by counsel. And so, I would ask if any of you are, in fact, represented by counsel today.

Mr. Hirsch? Make sure your microphone is turned on and pointed pretty much at your face. And identify your attorney for us, please.

Mr. HIRSCH. Yes, sir. Edwin Chessler of Corvas Sven & Moore. And Mr. Chessler is sitting behind me.

Mr. GREENWOOD. Very well.

Mr. Capek?

Mr. CAPEK. Yes, sir. Thomas Fitzpatrick and Patricia Braur sitting right behind me.

Mr. GREENWOOD. Very well.

Mr. Lorello?

Mr. LORELLO. Yes, sir. Robert Lorello.

Mr. GREENWOOD. Very well.

Mr. McGahan?

Mr. GREENWOOD. Very well.

And Mr. Davis?

Mr. DAVIS. Mr. Lustin.

Mr. GREENWOOD. Mr. Lustin, very well.

Welcome to all of the counsel.

At this point I would ask you as soon as you pour the water there, to stand and raise your right hands, please.

[Witnesses sworn.]

Mr. GREENWOOD. Okay, in so saying you are under oath.

And I will begin with you, Mr. Hirsch, and ask if you have an opening statement?

**TESTIMONY OF HAL HIRSCH, FORMERLY OF FULBRIGHT & JAWORSKI, FORMER COUNSEL TO HEALTHSOUTH; HOWARD CAPEK, FORMER MANAGING DIRECTOR, UBS WARBURG EQUITY RESEARCH AND HEALTHCARE GROUP; BENJAMIN LORELLO, HEAD OF GLOBAL HEALTHCARE FINANCE GROUP, UBS WARBURG; WILLIAM MCGAHAN, FORMER CO-HEAD OF GLOBAL HEALTHCARE FINANCE GROUP, UBS WARBURG; AND LANNY J. DAVIS, FORMERLY OF PATTON BOGGS, FORMER COUNSEL TO HEALTHSOUTH AND RICHARD SCRUSHY**

Mr. HIRSCH. I do not, sir. I am solely here to answer the questions of the committee, to the best of my ability.

Mr. GREENWOOD. Very well. I appreciate your being here.

Mr. Capek, do you have an opening statement, sir.

**TESTIMONY OF HOWARD CAPEK**

Mr. CAPEK. I have an opening written statement which I have submitted, and I am prepared to answer all of your questions. [The prepared statement of Howard Capek follows:]

PREPARED STATEMENT OF HOWARD CAPEK, FORMER MANAGING DIRECTOR, UBS AG

Mr. Chairman, members of the House Committee on Energy and Commerce, my name is Howard Capek. Until July of this year, I served as a Managing Director in UBS AG's Equity Research department.

I began my equity research career after earning a master's of business administration from the Johnson Graduate School of Management at Cornell University in 1993. Upon graduation, I joined Merrill Lynch as a healthcare research associate and was soon promoted to assistant vice president, working under one of that firm's senior analysts. I later joined Credit Suisse First Boston as a senior associate, after following the senior analyst with whom I had worked at Merrill Lynch. I was promoted to vice president in December of 1996, and in March of 1998, upon the departure of my superior, was named senior analyst following healthcare providers.

I joined UBS in May of 1999 as an executive director, providing research coverage to institutional investors on long-term care and alternate site healthcare providers. I was promoted to Managing Director in December of 2001. Over the past three years, I've expanded my research coverage to 35 companies across five health care sectors, including drug wholesalers and specialty distributors, prescription drug benefit managers, contract research organizations, alternate site providers and healthcare real estate investment trusts. When UBS completed its acquisition of Paine Webber in November 2001, I also began providing my research to retail shareholders.

During my time at UBS, I was consistently ranked in the top quartile among the approximately 75 analysts in the research department by the UBS institutional sales, trading and retail departments and research management. I was also ranked top 10 in categories of stock-picking, responsiveness to clients, and sector knowledge. In addition, I was ranked top-5 in stock picking by The Wall Street Journal 2002 all-star survey, a poll compiled solely on objective criteria. Over the last two and one-half year period, as well as the individual analyzed periods (calendar 2001, 2002, and the first six months of 2003), my buy-rated stocks have outperformed the major market and healthcare indices.

Of course, none of this meant that my stock picking was right all the time. However, I do believe it meant that the quantitative approach I took to analyzing stocks was beneficial to UBS clients. These clients felt comfortable using my research reports and earnings models to help them anticipate how a company might perform in the future, thereby contributing to their investment decision making process.

As with all equity stock market investing, no return can be guaranteed. Any of a thousand uncertainties can change anticipated return outcomes and the validity or success of any business model or bundle of assets. One of the greatest uncertainties involves the human element, the management of a company. Senior managers make decisions that can affect the value and profitability of a company and they also control a great deal of what the outside world gets to see. As with any member of the investing public, analysts must rely on the honesty, accuracy and completeness of audited and unaudited information that a firm's senior management team regularly makes available to the public.

My exposure to Healthsouth began while working at Merrill Lynch under Lucy Orwell, a top ranked analyst in the healthcare sector. Lucy decided to pick up coverage of the company in the mid 1990's, because it was a significant factor in several healthcare services sectors and because its large market capitalization made it one of the biggest such firms. We continued coverage of Healthsouth when the two of us moved to CSFB from Merrill, and I took over Ms. Orwell's portfolio of coverage, including Healthsouth, following her departure from CSFB in 1998.

Throughout much of the period I covered Healthsouth, I rated the stock a buy or strong buy. Throughout my entire career my ratings on every stock that I had covered were based on potential appreciation to a price target that I would expect the stock to eventually reach, typically one-year into the future. My price targets were derived from my projections of a firm's future cash flows and relative sector returns and cost of capital. My projections and modeling were ultimately based on audited financial information that was publicly available and whatever information Healthsouth management and their investor relations department routinely conveyed to me and the investment community.

One challenge that any analyst faces is supporting an investment thesis or recommendation over the long-term, despite short-term fluctuations in a stock, which can make those recommendations seem counterintuitive, particularly in retrospect. If an analyst were to change recommendations with trading momentum, he would inevitably be perceived as reactive rather than proactive, and would quickly become less valuable to his clients. Although there were times where the stock price performance of HealthSouth ran counter to my recommendations, I maintained that in the long term, the company's value would be better recognized. Indeed, from February 2000 through mid 2002, HealthSouth stock price performance supported this view.

With the benefit of hindsight, we now know that a significant portion of HealthSouth's financial history was predicated on fraud. Had I known this at any time, not only would I have never assigned it a positive rating, I would have dropped coverage of the company. For the many analysts in the sector that had positive ratings on HealthSouth, including myself, I do not believe that any of the operating changes and volatility that occurred from time to time in any way foretold the nature or magnitude of fraud that took place.

Another concern the Committee has raised in its investigation of the HealthSouth matter is the potential for conflict between investment banks and their stock research departments. Prior to the recent Wall Street settlements, a research analyst job description included, if not required, regular interaction and discussion with investment bankers. At times, such discussions gave bankers the opportunity to suggest coverage of certain stocks and required research analysts be available to lend their opinions on potential corporate transactions that involved banking services. That said, my record shows that the final word on coverage and ratings always fell first and foremost to my analysis and sector coverage considerations, and that my recommendations, based on quantifiable expected price targets, were always appropriate, unconflicted and fair.

At any point while a company I covered was on a "restricted list," that is to say where I was not permitted to publish research coverage due to investment banking, my interaction with clients complied with what I understood to be Firm policies at the time. The two widely publicized emails, which were taken grossly out of context by the media, were consistent with my understanding of UBS policy at that time.

Members of the Committee, what I have tried to demonstrate in these remarks is that, despite short term trends sometimes defying my recommendations; despite the challenges in maintaining continuity in research when dealing with restrictions imposed by investment banking; and despite the many uncertainties associated with stock picking, my efforts as an analyst have led to what I believe was an unbiased, modeled approach to research that benefited my clients in making their investment decisions. Throughout my entire career as an analyst, my intentions have been honest, my opinions have been independent and my actions have been proper.

Mr. GREENWOOD. Very well.

Mr. Lorello?

Mr. LORELLO. Yes. I would like to give an opening statement.

Mr. GREENWOOD. In that case, you are recognized for 5 minutes.

Did you submit a copy of your statement to the committee?

Mr. LORELLO. I believe the statement has been or will be submitted.

Mr. GREENWOOD. Will be. We would have liked to have had it before now, but you are entitled to present it. And so you are recognized for 5 minutes.

#### **TESTIMONY OF BENJAMIN LORELLO**

Mr. LORELLO. Chairman Greenwood, and members of the subcommittee, my name is Ben Lorello. Currently I am Managing Director of UBS and head of the Global Healthcare Investment Banking Group.

I am here today at the subcommittee's invitation to answer questions concerning the work UBS has done for HealthSouth. I will assist the committee in anyway I can, and would be glad to share some thoughts on potential ways to lessen the opportunity for this type of fraud that HealthSouth has brought to light.

I have worked in the investment banking industry for 25 years and have spent the last 20 or so managing healthcare groups. First at Salomon Smith Barney, and then at UBS.

I am proud to be an employee of UBS and proud of what the healthcare teams I have managed have accomplished during the last 2 decades in helping clients achieve their strategic goals and also in their capital formation.

HealthSouth was a client of UBS from 1999 until March 2003. UBS views HealthSouth as an important healthcare company, providing valuable services to millions of patients in modern facilities across the country. Indeed, due to the quality of the company's operations and many thousands of honest, dedicated employees, it appears that HealthSouth will be able to withstand the accounting fraud perpetrated by its former executives.

Throughout its relationship with HealthSouth, experience UBS deal teams conducted extensive due diligence on HealthSouth. Under UBS' systems of checks and balances, the firm's commitment committees evaluated the deal teams' due diligence and made an independent assessment of whether to proceed with each transaction.

UBS' due diligence started with and relied upon HealthSouth's audited financial statements. Until the announcements of criminal prosecutions against the HealthSouth officers in the spring of this year, I was not aware of or did not suspect that anyone at HealthSouth was engaged in any improprieties.

Further, I want to emphasize a point made by members of this subcommittee and underscored in the indictment filed yesterday, which is that HealthSouth management engaged in an elaborate conspiracy to cover up, conceal and keep secret the fraud from its auditors, its underwriters and lenders such as UBS, and from numerous other outsiders. As a result, HealthSouth's investors, dozens of underwriters and lenders and many companies who sold themselves to HealthSouth in return for stock, all of whom necessarily and appropriately relied on the integrity of the financial statements were by design misled and defrauded.

I believe the work of the subcommittee and others in Congress have done to expose to examine corporate fraud will limit these types of abuses in the future. The reforms implemented under the Sarbanes-Oxley Act will make corporate boards and audit committees for vigilant and corporate executives more accountable.

I can assure you that UBS for its part will continue its commitment to conducting its business with the highest ethical standards.

Thank you.

Mr. GREENWOOD. Thank you, Mr. Lorello.

Mr. McGahan, do you have an opening statement, sir?

You need to turn on your microphone, please.

#### **TESTIMONY OF WILLIAM MCGAHAN**

Mr. MCGAHAN. Mr. Chairman, my name is William McGahan, and I am a former employee of UBS. I have no opening statement, other than to say that I have tried as best as I can to assist the committee staff with its inquiry, and I am here today to answer any questions that you may have.

Mr. GREENWOOD. Thank you. And we appreciate it both of those things.

Mr. Davis, do you have an opening statement, sir?

#### TESTIMONY OF LANNY J. DAVIS

Mr. DAVIS. Yes, I do, Mr. Chairman.

Mr. Chairman, thank you for giving me this opportunity to respond to questions and to explain the role that I played in this matter.

First, I had no role regarding the accounting fraud issues that were the subject of the indictment. I was asked to provide legal media and crises management advice about the singular question about insider knowledge: What did Mr. Scrushy know and when did he know it.

I set three conditions to my representation when Mr. Scrushy and the Board asked me to undertake it.

First, full cooperation and transparency with the SEC.

Second, an honest and complete investigation of the insider information charges against Mr. Scrushy by a distinguished law firm.

And third, full waiver of attorney/client privilege so that the SEC would have immediate and complete access to all of the fruits of the investigation, not just the report itself, but all underlying materials so that they could continue the investigation wherever the evidence led.

In the absence of agreement on those three conditions, full transparency, an outside investigation and waiver of attorney/client privilege, I would not have undertaken this representation.

On the issue of transparency, I sent to the Chairman, to the Director of the Enforcement Division of the Securities and Exchange Commission on a Sunday evening after I received those commitments from Mr. Scrushy, the following email that you can find at Tab A of my testimony.

"I understand that it is also possible that that the Board of Directors will appoint another law firm to conduct its own review. The management of HealthSouth has given me full authority to communicate with your office and to commit to respond fully and cooperatively with any questions or concerns your office might have, to disclose the results of any inquires, to reveal promptly any improper conduct that may be ascertained, and, if appropriate, to assist the company in remedial efforts when and if it is determined that such are necessary.

Before an investigation had begun, before Fulbright & Jaworski had been retained, I had committed in writing to the Chairman of the Director of the Enforcement Division to waive all privilege and to send over the results of the investigation including underlying documents. And I did so with the knowledge and permission of the Board and Mr. Scrushy.

At one point Mr. Scrushy began to resist on my commitment of transparency. And there is another email that I would appreciate your looking at, which is at Tab B where I basically reminded Mr. Scrushy that I was not going to renege on that commitment, and I said in part in arguing against the full release of this report to the SEC, which Mr. Scrushy was now raising some weeks later,

“Not releasing the full report will look like a pullback on our prior commitment to transparency with little credible explanation.”

Second, Mr. Chairman, I was committed to a complete and accurate Fulbright & Jaworski report with no attempt—no attempt to influence the conclusions. I did ask Mr. Hirsch who headed up this investigation for the opportunity to hear the report read to me ahead of time. He objected, because he thought it would appear as if I was attempting to compromise the independence of his work. And, of course, I was not.

I had two reasons for asking him to do that, Mr. Chairman. The first is that I needed to prepare our media team for a public release of the conclusions of the report because I had committed to sending this over to the SEC and to releasing it publicly.

I assured Mr. Hirsch that my intention was not to influence in anyway the conclusions. In fact, my intention was to bolster the credibility and independence of his work, precisely because credibility was the issue in the media as well as at the SEC.

So at Tab C in answer to Mr. Hirsch’s legitimate concerns about reading me the conclusions ahead of time, I sent him an email. And I said to him the report is in “final form, and that would be the understanding BEFORE you read. Advance reading has no impact on Fulbright’s credibility.”

The second reason that I wanted it read ahead of time is that I was concerned that there may be open issues that would create uncertainties in which the media and the SEC would ask why did you not address those open issues. And it turns out after he read the report to the Board there were two open issues. One was the shredding issue, which we heard about for the first time on October 22. The other was what happened at a staff meeting where Mr. Scrusy might have been told about the possibility of the impact of this rule change.

So we asked Mr. Hirsch and his team to go back and reinvestigate and elaborate on this shredding issue, which I saw as explosive, legally as well as after Arthur Anderson and Enron in the media.

And second, I asked him to reinterview to the best he could everybody at this July meeting to close those two issues that were left open in the first report.

On October 29 he delivered two reports. One was the reinterview of the July meeting on the insider trading issue. The second was a much more extensive report on the shredding issue which led to the conclusion we cannot answer this definitively, let us turn both over the SEC.

So on October 29 and several days thereafter, despite some resistance from Mr. Scrusy, we kept our word and we sent all the reports, the preliminary report done in early February, the October 21 report with the two open issues and the October 29 report on shredding and report on insider information to the SEC with all of the underlying documents.

Now, there was one issue that arose between me and Mr. Horton. I learned from somebody at HealthSouth that despite my commitment to the SEC, that Mr. Horton had attempted to convince a Fulbright lawyer not to send over certain emails that showed some awareness by Mr. Horton and Mr. Owens of the impact of the rule

change prior to Mr. Scrushy exercising his stock options. I felt that by renegeing on our commitment at that point, especially if Mr. Horton was the influence behind that renegeing, that it would look like a conflict of interest by Mr. Horton, since I was worried that he was withholding the very same emails which evidenced that he had some foreknowledge. So I sent an email to Mr. Scrushy. And that email, unfortunately, has been put out in fragmentary fashion by a member of your staff. I urge you to read the entire email. Because the opening of the email expresses my concern that the Fulbright attorney was being influenced by Mr. Horton to renege on our commitment to send everything to the SEC. So I said we must cutoff Fulbright this morning, not this afternoon, but immediately before more harm is done. That is the only fragment released, or at least printed, by some of the members of your staff 2 weeks ago. But the rest of the email explains my concern about keeping the commitment the company had made to the SEC.

And so I then went on to say we must supervise—before more harm is done, other than the Fulbright attorney, and only if he is willing to be supervised by me and my law partner and not by Horton, who is the focus of the Board's investigation and Fulbright & Jaworski's, and likely the SEC's. At the very least, Horton's effort to convince the Fulbright attorney to assert a privilege and withhold documents from the SEC without consultation with me, constitutes a potential conflict of interest of him and the company.

So in conclusion, I had the greatest of respect for the job that Fulbright did and for the job that Mr. Hirsch did. It was never even slightly my intention to influence the credibility or perceived independence of that inquiry. And at the end of the day, after we handled the inside information allegation and released everything to the SEC, my job was over by approximately by December 2002 to early 2003.

Thank you.

[The prepared statement of Lanny J. Davis follows:]

PREPARED STATEMENT OF LANNY J. DAVIS

Good afternoon, Mr. Chairman.

Thank you for giving me this opportunity to report on my representation of HealthSouth Corporation and its former Chairman, Richard Scrushy.

In September 2002 I was asked by Mr. Scrushy and the HealthSouth Board of Directors to offer legal, media, and crisis management advice concerning published reports in late August that Mr. Scrushy may have improperly used inside information prior to his sale of substantial amounts of HealthSouth stock in May and late July 2002. The alleged inside information was that the federal Medicare agency, the Center for Medicare and Medicaid Services ("CMS"), had changed its rules on physical rehabilitation reimbursements, changes that would allegedly have had a substantial negative impact on HealthSouth's earnings.

The classic question raised in the media in late August 2002 when the story first broke on these insider trading issues was: What did Mr. Scrushy know about this Medicare rule change, and when did he know it?

I am proud of my work for HealthSouth in this matter, because, throughout my representation, I was faithful to three commitments I made to the SEC on HealthSouth's behalf when I began the engagement:

- First, full cooperation and transparency with the SEC;
- Second, an honest and complete investigation of the insider information charges against Mr. Scrushy by a distinguished outside law firm;
- And third, full waiver of attorney client and work product privileges so that the SEC would have immediate and complete access to all of the fruits of that investigation—not just the report itself, but all underlying materials—and could continue the investigation wherever the evidence led.

### *1. Commitment to Transparency and Cooperation With SEC*

From my very first conversations with Mr. Scrusby in early September 2002, I conditioned my willingness to represent him personally and the HealthSouth on his and the Board of Directors' express acceptance of these three commitments. They agreed.

I memorialized those commitments in an email I sent to Stephen M. Cutler, Director of the SEC's Enforcement Division, on Sunday evening, September 15, 2002, which you can find attached to my testimony as Tab A. This email was sent three days before the SEC decided to initiate its own investigation of Mr. Scrusby and HealthSouth. The key last two sentences of this email read:

"I understand that it is also possible that the Board of Directors will appoint another law firm to conduct its own review. The management of HealthSouth has given me full responsibility to communicate with your office and to commit to respond fully and cooperatively with any questions or concerns your office might have, to disclose the results of any inquiries, to reveal promptly any improper conduct that may be ascertained, and, if appropriate, to assist the company in remedial efforts when and if it is determined that such are necessary."

I always counseled HealthSouth and Mr. Scrusby to honor that commitment, even though they received conflicting advice at times from others. For example on October 21, 2002, shortly before Fulbright and Jaworski delivered its first report, Mr. Scrusby and others in senior management questioned whether the entire report should be released. I direct your attention, at Tab B, to an email I transmitted to the entire public relations and legal teams, dated October 21, 2002, at 12:00 AM that morning. Despite concerns raised by Mr. Scrusby and other company officials as to whether it was wise to transmit the entire Fulbright report to the SEC and release it publicly, I argued in favor of the company maintaining its commitment to give the SEC the full report. I stated, in relevant part:

"Not releasing it [the full Report] will look like a pullback on our prior commitment to transparency—with little credible explanation."

I am pleased to report that HealthSouth honored its commitment and shared with the SEC not only the report that Fulbright & Jaworski prepared, but all of the background materials that Fulbright relied upon, including documents, analyses, and reports of interviews. Many people and companies under investigation talk about full cooperation; very few, if any, deliver. Mr. Scrusby and HealthSouth deserve credit, not blame, for fulfilling the commitment I made to the SEC.

### *2. Commitment To Complete and Accurate Fulbright Report—With No Attempt to Influence Conclusions*

HealthSouth's hiring of Fulbright & Jaworski fulfilled its second commitment to the SEC—the retention of a nationally renowned law firm to complete an outside investigation into the insider trading issues. This Committee should understand that I counseled Mr. Scrusby and the Company to maximize, not undermine, the integrity of Fulbright's investigation. The Company's goal of weathering this crisis could only be achieved if the regulators, the media, and the market credited Fulbright's conclusions. I counseled—and HealthSouth and Mr. Scrusby understood and agreed—that only an honest, independent, and aggressive investigation would suffice.

With this in mind, I counseled Mr. Scrusby and the Company that a committee of independent Board members, and not the Company, should retain Fulbright so that their investigation would be truly independent in fact and would be recognized as independent by the courts, by the regulators, and by the public. The Company decided otherwise and directly retained Fulbright to conduct the investigation and to represent it before the SEC.

Our commitment to release the Fulbright report promptly inevitably complicated my efforts to advise Mr. Scrusby and the Company on the most effective means to communicate Fulbright's findings. In the typical situation, where reports such as these are closely guarded and selectively released, there is always plenty of time, after the report is prepared, to review its findings and to consider how to communicate them. But in a setting where we had committed to prompt release of the report, we did not have the luxury of time. To help formulate this advice, I asked Fulbright to show, or at least read to me, portions of its October 21, 2002 report before the date on which Fulbright delivered the report to the Board.

I had two reasons for asking Fulbright to show or read me the conclusions—neither of them had anything to do with attempting to influence the conclusions.

The first reason was to prepare the media team for public release of the conclusions of the report.

I assured Fulbright partner Hal Hirsch in an October 21 email, as I was trying to persuade him to read the report to me ahead of time, that I had no interest in

changing a single word of the Report, which I understood to be ready for transmittal to HealthSouth's Board of Directors. In asking Mr. Hirsch for the opportunity to review the Report shortly before its presentation to the Board, I emphasized: the Report "is in final form—and that would be the understanding BEFORE you read—advance reading has no impact on Fulbright credibility to the S.E.[C] [sic] or anyone else if factually neither he nor anyone else is able to make any changes." [Tab C].

The second reason I wanted to hear the final conclusions ahead of time was to permit me to advise Mr. Hirsch whether there were open issues left unresolved in the Report that might lead to additional questions in the media and, thus, continuing uncertainties in the public markets. I understood that for the Report to be credible, it had to be not just independent, but complete, leaving literally no stone unturned.

As things turned out, I was correct in this concern.

The October 21 Fulbright Report presented to the Board left open two important questions that needed further investigation: (1) the circumstances surrounding the shredding of documents during the time of the Fulbright review; and (2) whether Mr. Scrusby had heard about the Medicare rule change at a large staff meeting in early July 2002, several weeks before he exercised stock options and repaid Company loans.

At my and the Board's request, the Fulbright team undertook a supplemental investigation of both of these matters. On October 29, Fulbright presented two final Reports that more extensively addressed both those issues.

The October 29 Report concerning Mr. Scrusby's alleged insider knowledge confirmed the conclusions in Fulbright's October 21, 2002 Report: namely, there was no evidence uncovered by Fulbright to date that showed that Mr. Scrusby had inside knowledge of a material adverse effect of the CMS rule change.

A separate Report, also dated October 29, addressed the circumstances of the shredding more extensively. Fulbright could not reach any definitive conclusions about the shredding issue and determined that the SEC was in a better position to continue and complete that investigation.

But I want to emphasize two crucial and undisputed facts: First, I only asked to review the October 21 and 29 reports ahead of time and not to change any of Fulbright's conclusions in these reports; and, second, the purpose and result of my review of the first October 21 report was to urge Fulbright to conduct further investigation, not to soften any of its findings.

Both of these final October 29 reports, as well as the October 21 incomplete report and a preliminary two-page report dated October 2, were transmitted to the SEC as promised, and, as far as I knew at the time, the underlying emails and documents that were the basis of Fulbright's conclusions on the insider knowledge issue.

### 3. *Completion of Fulbright's Services—SEC To Continue Investigation With Benefit of All Fulbright Reports and Underlying Documents*

After Fulbright completed its final reports and sent them to the SEC, I recommended (with Mr. Scrusby's concurrence) that Fulbright no longer needed to continue billing time to HealthSouth. I did so for three reasons.

First, I believed it was more appropriate for the SEC, as the chief enforcement agency, to continue the investigation on this and other matters—without HealthSouth having to continue to be burdened by substantial additional legal expenses.

Thus, as you will note from the email to Mr. Hirsch dated November 6, and found at Attachment D, I stated to Mr. Hirsch:

"I have advised Richard [Scrusby] that with the investigation regarding himself completed, we will continue to fully cooperate with the S.E.C. and therefore do not need Fulbright's services any more." [Emphasis added].

Second, as I expressed in an email and in several telephone conversations in early November 2002—after the final reports had been delivered to the SEC—I was told that HealthSouth's general counsel might be attempting to persuade Fulbright to withhold certain documents from the SEC on grounds of attorney-client privilege, which would have been a breach of HealthSouth's commitment to the SEC, as I had stated in my email of September 15 to the Director of the Enforcement Division of the SEC.

The Company's general counsel, Mr. William Horton, had told me directly on several occasions that as a general matter he did not favor turning over all documents to the SEC and waiving attorney-client and work product privilege. I did not question his sincerity in taking this position. I did question his judgment, however, in light of the position I had previously taken with the SEC.

Further, among the documents underlying the October 21 and 29 Fulbright Reports were certain emails authored by Mr. Horton that suggested that he had some

knowledge and concerns, before Mr. Scrushy's stock transactions, that the CMS rule change might have a significant negative impact on the Company's earnings. I was concerned that some of the documents Mr. Horton reportedly wanted to refrain from delivering to the SEC might be these same emails creating at least the appearance of a potential conflict of interest.

On or about November 3, I was told by a HealthSouth official that Mr. Horton might be trying to convince an attorney from Fulbright not to send all the underlying documents and emails to the SEC. Therefore, on November 4, I sent Mr. Scrushy an email (found at Attachment E) stating that Fulbright should be terminated immediately because "Horton's effort to convince [the Fulbright attorney] to assert a privilege and withhold documents from the SEC without consultation with me constitutes a potential conflict of interest for him and the Company."

To this day I am not sure whether Mr. Horton, in fact, was taking this position with respect to these specific documents. I certainly am not suggesting that he was doing anything improper. But I was concerned enough to write this email at the time.

The third reason I believed that Fulbright did not need to continue any investigation was that Special Litigation Committee of the Board had retained its own outside and independent counsel to investigate the same transactions at issue in the Fulbright investigation. The Committee had done so to help it defend a civil stockholder derivative lawsuit. The Company did not believe that it should pay two separate law firms to continue investigating the same transactions, and I agreed.

To repeat: Clearly my overriding concern was maintaining the Company's commitment to the SEC concerning transparency and waiver of privilege—and preventing the harm that might be done to the Company and its shareholders if that commitment were renegeed upon.

To this day I have nothing but the greatest respect for the integrity and professional skills exhibited by Mr. Hirsch and his colleagues at Fulbright & Jaworski for the job they did in these very difficult circumstances. Nothing I have seen or heard since then casts any doubt upon the integrity of their conclusions or the independence of their efforts.

#### Conclusion

I appreciate the chance to clear up any questions about my role in the HealthSouth matter. We tried to learn and apply the lessons of Enron and the high standards of Sarbanes-Oxley. My role in HealthSouth was to counsel for and to insist upon transparency and cooperation. That was sound legal advice, good corporate governance, and the only truly effective way for HealthSouth and Mr. Scrushy to address the questions that had been raised.

11/03/2003 14:24 FAX 202 339 8500

ORRICK

007/011

09/15/02 01:01am From: PATTON BOGGS LLP

202-457-4470

T-773 P.07/12 F-327

Veneracion, Susana

A

From: Davis, Lanny  
 Sent: Sunday, September 15, 2002 11:19 PM  
 To: Rasmussen, Glenn; Larson, Raphael; Goldberg, Adam; Fishman, Ira; O'Connor, Eileen; Laboschin, Debra; Klein, Michael; Martinez, Vince  
 Subject: Fw: HealthSouth - From Patton Boggs LLP Washington D.C

FYI

-----Original Message-----

From: LDavis145@aol.com <LDavis145@aol.com>  
 To: cutlers@sec.gov <cutlers@sec.gov>  
 CC: ldavis@pattonboggs.com <LDavis@PattonBoggs.com>; LDavis145@aol.com <LDavis145@aol.com>  
 Sent: Sun Sep 15 21:16:30 2002  
 Subject: HealthSouth -- From Patton Boggs LLP Washington D.C

To: Stephen M. Cutler, Director of Enforcement Division, Securities and Exchange Commission  
 From: Lanny J. Davis, Patton Boggs LLP

I and my firm, Patton Boggs, located in Washington D.C., have been recently retained by HealthSouth, a public company located at One Health South Parkway, Birmingham, Alabama 35243. I intend to conduct a thorough review of all issues pertaining to the issuance of a press release on August 27, 2002, which announced a material reduction in previously projected earnings for 2002 of approximately \$175 million. I understand that it is also possible that the Board of Directors will appoint another law firm to conduct its own review. The management of HealthSouth has given me full authority to communicate with your office and to commit to respond fully and cooperatively with any questions or concerns your office might have, to disclose the results of any inquiries, to reveal promptly any improper conduct that may be ascertained, and, if appropriate, to assist the company in remedial efforts when and if it is determined that such are necessary.

If you have any concerns or questions, please feel free to call me. Patton Boggs is located at 2550 M Street N.W. Washington D.C. 20037. Tele. 202-457-6490. My email address is copied above.

PB 15475

1

11/03/2003 MON 14:22 [TX/RX NO 8028] 007

11/03/2003 14:24 FAX 202 339 8500

ORRICK

008/011

Oct-31-03 01:01pm From: PATTON BOGGS LLP

202-457-4478

T-773 P.08/12 F-327

**Molendez, Madolene****(B)**

From: Davis, Lanny  
 To: Monday, October 21, 2002 12:00 AM  
 "hirsch@fulbright.com"; Goldberg, Adam; "whenson@usstrategies.com";  
 "jason.hervey@healthsouth.com"; "rjmay@aol.com"; "bobmay9788@msn.com";  
 "jpowell@webershandwick.com"; "stata@webershandwick.com";  
 "hschwartz@webershandwick.com"; "michael.deaver@edelman.com"; "tollis.rafkisax@edelman.com"; "rscruhy@healthsouth.com"  
 Subject: Urgent--Privileged Attorney Client and Work Product

Talked to RS for one hour late tonite and conferred with Bob May too. RS now leans in favor of public release of complete Fulbright Report on Wed am after presentation to Board on Tues. Bob May agrees.

This is of course subject to everyone on this email list hearing the report read in full by Hal some time on Monday--and perhaps reading along with Hal if he can email us penultimate draft, as he has indicated to me.

In my opinion, after discussion with most of you Sun nite, just releasing the first section on methodology and just last paragraph clearing RS will lack context and credibility. I also believe once everyone hears the full factual chronology in the Fulbright Report, all will conclude that it needs to be available to shareholders and the public, and that it provides a critical basis for accountability and remediation by the Board--something shareholders are demanding and the press is waiting for. Not releasing it also will look like a pullback on our prior commitment to transparency--with little credible explanation.

Adam--please set up conf call with all on the above email list so that Hal can read the report to all first thing in am. I will be out of town and returning to DC at 2 pm EST. I propose a second conf call at 4 pm EST to reach final commitments on strategy.

PB 01909

11/03/2003 MON 14:22 [TX/RX NO 8028] 008

Oct-31-03 11:38am From: PATTON BOGGS LLP

202-457-4476

T-769 P.02/02 F-323

Hirsch, Hal

5

From: Davis, Larry [LDavis@PattonBoggs.com]  
 Sent: Monday, October 21, 2003 8:09 AM  
 To: 'Hirsch@fulbright.com'  
 Subject: Re: Urgent-Privileged Attorney Client and Work Product

If it is in final form--and that would be understanding BEFORE you read--  
 advance reading has no impact on Fulbright credibility to S.I.X. or anyone  
 else if factually neither he nor anyone else is able to make any changes. He  
 is entitled to hear report ahead of time.  
 Truly your one sentence response was not constructive.

This e-mail message contains confidential, privileged information intended  
 solely for the addressee. Please do not read, copy, or disseminate it  
 unless you are the addressee. If you have received it in error, please call  
 us (toll-free) at (800) 457-6000 and ask to speak with the message sender.  
 Also, we would appreciate your forwarding the message back to us and  
 deleting it from your system. Thank you.

To learn more about our firm, please visit our website at  
<http://www.pattonboggs.com>.

CONFIDENTIAL TREATMENT REQUESTED  
 By Dechert LLP on behalf of its client

FJ 009997

\*\* TOTAL PAGE.02 \*\*

10/30/2003 THU 16:02 [TX/RX NO 8283] 003

11/03/2003 MON 14:22 [TX/RX NO 8028] 009

11/03/2003 14:24 FAX 202 338 8500

ORRICK

010/011

Oct-31-03 01:02am From: PATTON BOGGS LLP

202-487-4470

T-773 P.11/12 F-227

D

**Melendez, Madelene**

**From:** Davis, Lanny  
**Sent:** Wednesday, November 08, 2002 7:27 PM  
**To:** 'hirsch@fulbright.com'  
**Cc:** 'rscrushy@healthsouth.com'; 'pungit@fulbright.com'; Sjoquist, Mary  
**Subject:** Privileged--HealthSouth

Richard Scrushy has just instructed me to inform you that, other than Peter Unger and colleagues working with him and the S.E.C., no work will be done for HealthSouth by Fulbright effective immediately. I have advised Richard that with the investigation regarding himself completed, we will continue to fully cooperate with the S.E.C., and therefore do not need Fulbright's services any longer.

I must remind you -- again -- that Richard has asked me to advise you to stop communicating with him or any other HealthSouth official except through his outside counsel, Patton Boggs. Please call Mary Sjoquist if you have any need to further communicate. (202-457-6404).

PB 01791

11/03/2003 MON 14:22 [TX/RX NO 8028] 010

11/03/2003 14:24 FAX 202 339 8500

ORRICK

011/011

Oct-31-03 01:02pm From: PATTON BOGGS LLP

202-457-4470

T-773 P.10/12 F-327

**Melendez, Madelene****(E)**

**From:** Davis, Lanny  
**Sent:** Monday, November 04, 2002 6:35 AM  
**To:** 'lacrushy@healthsouth.com'  
**Cc:** 'jason.harvey@healthsouth.com'; 'ahanson@usstrategies.com'; Sjoquist, Mary  
**Subject:** URGENT-Attorney Client Privileged

Backdoor conversation yesterday between Hirsch and Horton without my knowledge almost did us in again by blowing up importance of release. Only thanks to Jason late last night did I learn of it and head it off by calling Horton. I told him we did not need to issue release until 2 or 3 pm today. He told me he would await your instruction.

We must cutoff Fandl this morning--not this afternoon, but immediately--before more harm is done, other than Peter Unger, and only if he is willing to be supervised by me and Mary Sjoquist, and not by Horton, who is the focus of the Board's investigation (and Fandl's) and likely the S.E.C.'s. At the very least Horton's effort to convince Unger to assert a privilege and withhold documents from the S.E.C., without consultation with me constitutes a potential conflict of interest for him and the Company.

May I communicate this directly to Hal and Peter on your behalf?

Please email me or call me immediately if the answer is yes. And then I will arrange three-way call with you, me, and Peter.

PB 01809

21

11/03/2003 MON 14:22 [TX/RX NO 8028] 011

Mr. GREENWOOD. Thank you, Mr. Davis.

And just for the record, our staff releases only entire emails, not fragments thereof. And so what is printed is beyond our control as well.

Mr. DAVIS. I understand.

Mr. GREENWOOD. Thank you.

The Chair recognizes himself for 10 minutes for questioning.

And I want to start with Mr. Capek.

The reason that this committee holds hearings, holding this hearing on this matter and the reason that we have held other hearings is ultimately to find out whether the laws and the processes that are in place to protect the investor are working. And in the case of HealthSouth, we found out that barricade after barricade that was supposed to be erected to protect the investor were breached. The employees who had the responsibility to give the investors honest information, failed to do that. The Board of Directors, for right or wrong as we learned this morning, were unable to protect the investors from this fraud. The accountants were unable to protect the investors from this fraud. And that is not to say we are guessing blame there, it is just the fact the matter is that they testified that they could not do that.

One of the barricades that is erected in our economic system is the stock analyst. And, of course, as you well know, Mr. Capek, you have a very important responsibility in trying to make sure that investors have good honest information with which they can base their judgments and make a whole economic system work.

I am going to ask you, Mr. Capek, to turn to Tab 1 in the binder there. This is a report you published on HealthSouth in May 1999, and in big bold letters on the first page is the word or the words "strong buy." Do you have that document, sir?

Mr. CAPEK. It starts on the first pages, a fax to L. Murphy from myself?

Mr. GREENWOOD. Yes. The second page of that document.

Mr. CAPEK. The second page, the draft, dated June 4. Yes, sir.

Mr. GREENWOOD. Right. Okay. Would you identify the document, please?

Mr. CAPEK. This is a research report, a draft, dated June 4, 1999 written by me with my current rating at the time on HealthSouth, which was a strong buy.

Mr. GREENWOOD. Okay.

Mr. CAPEK. The title of the report is "Reiterating the Strong Buy, Dispelling Some Near Term Market Concerns."

Mr. GREENWOOD. Very well.

What does "strong buy" mean to an investor. What are you trying to signal to the investment community when you say strong buy?

Mr. CAPEK. That my price target, which according to the report here, was \$20 and the stock was trading at \$14.44 at the time; is greater than a 20 percent upside to my price target or what I would theorize as my fair value of the company roughly 12 months out from now.

Mr. GREENWOOD. So would a strong buy imply as well that you do not see any immediate downside to the company, is that right?

Mr. CAPEK. No. It is a rating that I have applied for the last year and half. It is not even a category a strong buy rating that the firm, UBS, has. But, no, there can be volatility with the stock up or down.

Mr. GREENWOOD. Right. But it does mean that the stock is at a price where it should be bought. You're recommending people buy it and continue to do well in the foreseeable future?

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. Okay. Would you please turn now to Tabs 3 and 4 in your binder? And identify the document in Tab 3. I will identify it. There are two separate emails written to Susan Zeeb by you in response to her questions about HRC, which refers to HealthSouth. Is that correct?

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. Have I correctly identified the document.

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. Okay. Let us look at the first email on Tab 3. This is written a few months after you have indicated that HealthSouth was a strong buy, which is as we just discussed. And you state "I would love to publish on this pig, then I would not be spending so much time in Birmingham in July/August, at least there is no humidity. Okay. On HRC, what is your fax number, I will send you a few charts and graphs which should glaringly highlight the company's inability to collect and convert sales into cash and also their inability to reinvest cash at good rates of return."

Would you agree that this is not a positive statement about HealthSouth's stock?

Mr. CAPEK. It is a reactionary statement to Ms. Zeeb's original email, which I believe the reply separator is dated below, where she seems to be responding to "it's acting like such a pig again," the stock price. So in hindsight being the perfect looking glass that it is, I would have in my response put the word "pig" in quotes because responding to what she was saying or asking—

Mr. GREENWOOD. Was that the kind of language you would use to recommend that she buy that stock?

Mr. CAPEK. No, sir.

Mr. GREENWOOD. Okay.

Mr. CAPEK. I was not—I did not have a strong buy recommendation on the stock at this point in time.

Mr. GREENWOOD. What recommendation did you have at this point in time?

Mr. CAPEK. I did not have a rating. I was restricted on the stock. Shortly after the last research report that you referenced in Tab 1, sometime in mid-June I was restricted on HealthSouth stock.

Mr. GREENWOOD. Okay.

Mr. CAPEK. So I did not have a rating.

Mr. GREENWOOD. Yes. Were you aware when you wrote the strong buy recommendation that—and did you have in your possession charts and graphs which would glaringly highlight the company's inability to collect and convert sales into cash and their inability to reinvest cash at good rates of return?

Mr. CAPEK. Yes, sir. Actually, the draft report, dated June 4 that you referenced in Tab 1, was a summation of high points from my larger report dated May 18. And actually, as I was going to con-

tinue, the charts and graphs that I was sending Ms. Zeeb were my analysis of historical return on invested capital, margin analysis, spending trends, all based on historical data and all of it that was published in the May 18 report on HealthSouth.

Mr. GREENWOOD. When you used the term “pig” what did you mean?

Mr. CAPEK. I was——

Mr. GREENWOOD. I know you were echoing her, but you——

Mr. CAPEK. I was just taking the word that she said and putting it into my response. She was referring the stock as acting like a pig again, assuming she meant volatility on August 18/19 when these were written. And I was just putting it back in there to her. It didn't mean anything beyond that.

As I said, if I had put it in quotes or if I had not put it in at all——

Mr. GREENWOOD. Well, how can you explain what appears to us to be two polar statements about this company? Strong buy, which is your official statement that you send out to investors and in a private email saying nothing but negative things about this company, particularly as I have said and read a couple of times here, the company's inability to collect and convert sales into cash and their inability to reinvest cash at good rates of return? Those qualities do not seem like the qualities of a company that one would normally expect to receive a strong buy recommendation, do they?

Mr. CAPEK. They can be. And in my May 18 report was the theory was the trend would reverse in the near term. There is a cycle to cash collection. There is a cycle capital spending. And you want to own the stock when the cycle is at the inflection point. And when I wrote the report in May, my strong buy rating in June when the follow reiteration, my thoughts were the next quarters based on the managed care or commercial pricing cycle and how they pay their bills, and how HealthSouth had been spending money, that that cycle would turn. And you would be in what I would call a cash hog mode or the company would be.

So my strong buy rating is on the stock and I regret using the word “pig” in response to when my institutional client used it, it was poor judgment. But beyond that, I was not changing my investment——

Mr. GREENWOOD. Well, did you think that your email to her would be the kind of email that would prompt her to invest in this company?

Mr. CAPEK. I was not trying to elicit her to buy or sell the stock. I was responding to her. I thought maybe she had not seen or did not have a copy of my large report from May. Here are these historic charts and graphs, take a look. I was trying to help her explain the trading activity that she referred to that the stock was acting like a pig.

Mr. GREENWOOD. You said that you were restricted. Why were you restricted?

Mr. CAPEK. In mid-June I was asked to participate in a piece of presentation to the Board at HealthSouth to discuss the split out of the company into two pieces. The in-patient business and the out-patient business. And at the time I was still involved in working on that. It was publicly disclosed by the company that they

hired UBS Warburg to advise them on that, and that is what I was doing. So I was not publishing on HealthSouth.

Mr. GREENWOOD. So you were not allowed to publish reports and you also were not allowed to discuss material issues about the company with outside investors, is that right?

Mr. CAPEK. Correct.

Mr. GREENWOOD. Okay. Let us look at the next email at Tab 4. This is dated September 10, 1999, also to Ms. Zeeb. And in this email, again, referencing HealthRC, HealthSouth, you state "I would not own a share." Is this statement consistent with your strong buy rating of HealthSouth?

Mr. CAPEK. Again, I did not have a strong buy rating at the time. I was still restricted. But to put this email in context, on Friday, September 10, on Thursday September 9 HealthSouth announced that they were not going to go forward with the split up of the company and that they were taking charges, they were reducing earnings guidance, changing some management spots and a whole bunch of stuff along those lines.

So, again, I do not know why we do not have the rest of, but I was responding again to Ms. Zeeb, and I was commenting knee-jerk to that press release of less than a day before saying what a mess. I just would not own a share right now.

Mr. GREENWOOD. And would you have owned a share when you made your strong buy recommendation?

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. Okay. And the vents that you just listed occurred prior to your strong buy recommendation—after your strong buy recommendation but prior to your declaration that you would not own a share?

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. Okay. Were you aware at the time that you wrote these emails that you were on a restricted list regarding HealthSouth?

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. Okay. Had UBS informed you that you were no longer on the restricted list during the time you wrote these emails?

Mr. CAPEK. No, sir.

Mr. GREENWOOD. Okay. When you re-initiated coverage of HealthSouth—

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. [continuing] how did you rate it then?

Mr. CAPEK. In February 2000, I re-initiated coverage on HealthSouth with a strong buy.

Mr. GREENWOOD. Okay.

Mr. CAPEK. At the time I initiated coverage again, February 2000, keeping in mind again my rating is commiserate to the upside potential and what I think the stock is fairly valued at. The stock was \$5. My price target was \$11, I believe. Contrast that to my May rating where the stock was \$14, my price target was \$20. So valuation parameter had changed based on while I was restricted the company reported two quarters of earnings, expectations had come down, the stock gone down to 5. And on a clean

slate, I thought the \$5 stock was worth 11, based on the projections, forecasts I had then in February.

In fact, actually the stock went up over the next 18 months going to high teens. But be that as it may, yes, I re-initiated coverage in February 2000 with a strong buy.

Mr. GREENWOOD. So the only time that you would not buy a share was the time during which you were restricted, is that right?

Mr. CAPEK. Coincidentally with timing of announcements and what it says in the emails, yes.

Mr. GREENWOOD. Okay. So your testimony is that in June when you wrote—when did you write your strong buy recommendation? Was that in June?

Mr. CAPEK. My initiation of coverage was in the end of May 1999. Excuse me. The June 4 graph that you referred to was a reiteration of that report.

Mr. GREENWOOD. Okay. So between June 4 and February, which were your two strong buy recommendations—

Mr. CAPEK. Yes, sir.

Mr. GREENWOOD. [continuing] you went from strong buy to pig can't earn money, I would not own a share of it back to strong buy?

Mr. CAPEK. I was restricted on the stock in mid-June, and when I re-initiate coverage, that time line of events the way the company disappointed two expectations reported results—yes, sir. Given the way the stock price traded, yes.

Mr. GREENWOOD. My time has expired.

The gentlelady from Colorado is recognized for 10 minutes.

Ms. DEGETTE. Mr. Capek, there is another email that is not in the book. If we can have staff give you a copy of it. This is an email from Susan Lee to you, dated Tuesday, September 24, 2002. And what Ms. Lee says in this email is that several of your institutional clients were concerned about HealthSouth's high capital expenditure figures quarter after quarter and were worried that HealthSouth was capitalizing expenses. And she even says similar to what WorldCom was doing. And in her email she says that when talking to your client, she tried to "concentrate on strong cash, but that it did not sound like he was buying it." She continued by saying that she was aware that HealthSouth "is expanding their facilities and that there are some maintenance costs." And then she asks "Are we looking at anything else here?" Do you recall getting that email from her?

Mr. CAPEK. I have seen it in the process of gathering and reviewing documents for the last—since March, but I do not recall it.

Ms. DEGETTE. You do not remember specifically?

Mr. CAPEK. No, ma'am.

Ms. DEGETTE. But do you remember some discussions during that time period of September 2002 wondering about the capitalizing of expenses of HealthSouth?

Mr. CAPEK. In September 24—on September 24—well, Susan Lee was my associate.

Ms. DEGETTE. Yes, I know.

Mr. CAPEK. Okay. Yes, and that—

Ms. DEGETTE. I mean, these are pretty serious allegations in here, would you not say so?

Mr. CAPEK. I would not call them allegations. But, yes, they are serious and they are points that I have scrutinized with the company over time, and investors had been aware of.

Ms. DEGETTE. You had scrutinized the issue of whether there were high capital expenditure figures?

Mr. CAPEK. Yes.

Ms. DEGETTE. And what was your conclusion?

Mr. CAPEK. The company was investing, they were opening new facilities or hospitals. And at some point it would slow. I mean, cap X did fluctuate year to year. In 2002, we are to the point September 24 that the earnings—

Ms. DEGETTE. Let me ask you something, how long have you been in the business?

Mr. CAPEK. Ten years, roughly.

Ms. DEGETTE. Ten years. And I think you said at least in your written testimony you have kind of a complex method by which you decide whether you recommend buy or not, right?

Mr. CAPEK. Yes.

Ms. DEGETTE. So do you concentrate on healthcare enterprises?

Mr. CAPEK. I cover only healthcare services.

Ms. DEGETTE. Now, during this period in 2002, or you know 1999 to 2003, were the capital expenditure figures for HealthSouth different from other similar healthcare entities? Did you look at that?

Mr. CAPEK. Yes, I did look at it on the per bid basis or as a percentage of total cash-flow. And it is not out of line.

Ms. DEGETTE. It did not seem that different to you?

Mr. CAPEK. No.

Ms. DEGETTE. Okay.

Mr. CAPEK. When you look at—

Ms. DEGETTE. Now—

Mr. CAPEK. If I can?

Ms. DEGETTE. I'm sorry.

Mr. CAPEK. At September 24, you are less than 1 month after the August 27 announcement from the \$175 million reduction, a number of things going on. The company points to slowdown in surgery volume trends. So the stock had traded down. When you look at complex valuation methodologies, one of the things at this point and well before September 24 as one of the investment risks in my research, I pointed out management's credibility with hitting cap X targets and other things. So I do not think there is anything new being discussed here.

Ms. DEGETTE. I am having difficulty understanding you. I am sorry, if you could just speak into the mike.

Mr. CAPEK. Okay.

Ms. DEGETTE. Thank you.

Mr. CAPEK. I said September 24, the date of this one email, it is less than 1 month—

Ms. DEGETTE. No, I heard that part.

Mr. CAPEK. Okay.

Ms. DEGETTE. But my question is then if there was a lot going on, do you recall calling this investor and talking to him about all of these issues, management credibility and all these things?

Mr. CAPEK. I do not recall, and I do not know these institutional investors, for what firms they work at, who they are. If Susan asked me to call them back, I am sure I did either from the road or—

Ms. DEGETTE. But you do not recall that conversation?

Mr. CAPEK. No. And on average—

Ms. DEGETTE. Were you aware that after 2000 that HealthSouth did not make any more facilities acquisitions. And, in fact, they were closing facilities?

Mr. CAPEK. Yes, ma'am.

Ms. DEGETTE. So what were they spending their capital expenditure money on if they were actually closing facilities?

Mr. CAPEK. They were consolidating—

Ms. DEGETTE. Did you wonder about that?

Mr. CAPEK. They were consolidating out-patient facilities. So if you were closing an MRI facility or a diagnostic center, the actual magnet or whatnot was being moved to another location that was already there. And, actually, at this point—

Ms. DEGETTE. So what you are saying they were not really closing facilities, they were just shifting them?

Mr. CAPEK. They were closing some of those out-patient and satellite facilities.

Ms. DEGETTE. Right.

Mr. CAPEK. They were also opening nine new hospitals. And hospitals—

Ms. DEGETTE. So you thought that was where the capital expenditures had—

Mr. CAPEK. Roughly a \$100 to \$120 million a hospital, yes.

Ms. DEGETTE. Okay. Now, were you concerned about what Susan Lee was saying in this email?

Mr. CAPEK. I was concerned, as I said, and I wrote about my concerns and risk factors in my written document—my written—

Ms. DEGETTE. Do we have those? Does the committee have those?

Mr. CAPEK. In my interview, yes, we went through my packet of research. But—

Ms. DEGETTE. No, wait. I am sorry. Is that answer yes we have those documents?

Mr. CAPEK. Yes.

Ms. DEGETTE. Okay.

Mr. CAPEK. And if you do not, I will be happy to get them to you.

Ms. DEGETTE. Okay. Now, I have another question. I would like to get them. I do not know. Do we have those? Staff does not know. If you can provide us with another copy, that would be very helpful.

Now, as recently as March 2003 the company was, obviously, unraveling. There was a Department of Justice probe. There was Transmittal 1753. There were all these news articles. Mr. Davis can tell us all about what was going on in that period. Yet you were still making a buy rating. Can you please tell me your rationale for that?

Mr. CAPEK. Yes. And, again, my methodology of rating stocks is based on what I expect the stock to trade at in fair value. There

was still roughly \$3 plus of tangible book value on the company and the stock was trading between 5 and 6. When I looked at—

Ms. DEGETTE. Well, were you concerned about the effect that all of these other issues like the Department of Justice probe and Transmittal 1753, etcetera, would have on the business. I mean, you had actually been expressing these concerns way back to 1999 in various ways, right?

Mr. CAPEK. Yes. And to answer your question, yes, I did have those concerns. But I also felt or estimated that at \$5 a share, the way the stock was trading and based on what—based on audit financial for many years at tangible book value per share with \$300 million in cash, the coverage ratios—I mean your concerns, when you are asking my concerns about capital spending, you tie those into my projections for cash-flow and coverage ratios. Can this company service its debt. I cover the healthcare rates, which many of my competitors do not. The real estate companies that own the facilities. In the case of the rates that had business or had rents outstanding to HealthSouth, HealthSouth was current within 1 month of all of their rents. And they remain that way through today, by the way.

So, yes, I was concerned, cognizant—

Ms. DEGETTE. Even though their stock has plummeted? I mean, if someone had actually bought the stock in March 2003, they would have lost a lot of money, right?

Mr. CAPEK. I have not followed the stock since.

Ms. DEGETTE. Okay.

Mr. CAPEK. But probably. At some point the stock was .08 cents, and I think today it is—

Ms. DEGETTE. Well, let me just ask you—I am sorry, they only give us limited time.

Mr. CAPEK. It is okay.

Ms. DEGETTE. Yes. Wrap up.

Mr. CAPEK. Yes, I was concerned. But relative to where the stock was trading, the tangible book value and what I expected based on historic results what their true cash-flow was, the company was okay.

Ms. DEGETTE. Now, before 2002 when Attorney General Spitzer entered into the settlement with all the investment banking companies, a number of firms were both performing banking and research analyst functions. And I am wondering if your firm was doing that with HealthSouth?

Mr. CAPEK. I was never called on to perform banking functions.

Ms. DEGETTE. No, no. I am talking about your firm. Were people doing banking and research analyst functions at your firm?

Mr. CAPEK. No. Not—in healthcare and to what I was exposed to, no. Healthcare research analyst reported to research and—

Ms. DEGETTE. Mr. Lorello, do you know the answer to that question? Was your firm performing banking functions and also research analysis functions?

Mr. LORELLO. On the same companies?

Ms. DEGETTE. On HealthSouth?

Mr. LORELLO. Yes.

Ms. DEGETTE. Tell me, if you know, what percentage of the income your firm received from HealthSouth was received from banking and what was received from research analysis?

Mr. LORELLO. I cannot give you the statistic on the research, but I can give it to you on the banking.

Ms. DEGETTE. How much was from banking?

Mr. LORELLO. Approximately 2 percent of our group's revenues of the healthcare group's revenues came from HealthSouth.

Ms. DEGETTE. And what was the rough amount of that revenue? I do not know what your group's revenues were, so I do not know what 2 percent is.

Mr. LORELLO. I think in any given year, about \$5 to \$6 million.

Ms. DEGETTE. Okay. And what about the research analysis. You do not know how much of your firm's income came from that?

Mr. LORELLO. Well, yes. That question would be the sales and trading commissions that we generate from research and on the equity side, I just do not know the answer to that.

Ms. DEGETTE. Mr. Chairman, I would ask if either this witness or someone else from the company can supplement in writing the answers to give me that information.

Do you know, Mr. Lorello, is your firm now performing both of these functions for HealthSouth? Both banking and the research?

Mr. LORELLO. Well, we no longer have a relationship with HealthSouth.

Ms. DEGETTE. Okay. So the answer is no.

Mr. LORELLO. Yes.

Ms. DEGETTE. Are you doing it for anybody?

Mr. LORELLO. Well, with the Spitzer legislation that has resulted in the settlement, is a complete and total separation now between banking and research.

Ms. DEGETTE. There is a firewall, right?

Mr. LORELLO. It is even thicker than that.

Ms. DEGETTE. Okay. Thank you.

Thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentlelady.

The gentleman from Florida is recognized for 10 minutes.

Mr. STEARNS. Mr. Chairman, thank you.

And, Mr. Hirsch, I would just like to chat with you briefly here. You were hired at the request of Mr. Davis, is that—

Mr. HIRSCH. I was hired by Fulbright & Jaworski.

Mr. STEARNS. Yes.

Mr. HIRSCH. Who was hired by HealthSouth. I believe at the recommendation of—

Mr. STEARNS. Of Mr. Davis.

Mr. HIRSCH. Yes, sir.

Mr. STEARNS. Yes. Okay. And you came in and you did a report on October 1, 2002. You did another report on October 21, 2002. Then you had two more reports on October 29. Is that true?

Mr. HIRSCH. Yes, sir. And one on March 14, 2003.

Mr. STEARNS. Okay. Right.

As a result of these reports, did you think at that time that your investigation cleared Mr. Scrushy of any culpability dealing with the sale, inside trading?

Mr. HIRSCH. I am not certain from your question as to what that time was. But if I can—

Mr. STEARNS. I mean, as a result of these four reports and the additional reports that came, did you in your own mind feel my reports pretty much show consistently that Mr. Scrushy did not know, and when you—he did not know about the \$175 million shortfall. And then when he sold the stock, that it was not insider trading. Do you feel comfortable at saying at that point your report said that?

Mr. HIRSCH. No, sir. My report never said that.

Mr. STEARNS. Right.

Mr. HIRSCH. And in fact, prior to the issuance of any of the reports and at the time of the engagement, I advised Mr. Scrushy, the Board and all other related counsel that we would never be able to say that.

Mr. STEARNS. No.

Mr. HIRSCH. I advised that we would not be able to prove a negative. That we would most likely, at best if there was in fact a complete inability to establish that Mr. Scrushy had done it—

Mr. STEARNS. Okay.

Mr. HIRSCH. [continuing] the negative.

Mr. STEARNS. Okay. Then on October 30, 2000, there was a press release issued by HealthSouth. Did you receive a copy of this press release?

Mr. HIRSCH. I received a copy of that press release, sir.

Mr. STEARNS. And the press release said HealthSouth Chairman Richard Scrushy cleared by outside investigation of advanced knowledge of Medicare rule change prior to stock transaction. Did you know about the press release?

Mr. HIRSCH. I saw the press release on the morning of the 29th, I believe.

Mr. STEARNS. And I guess the basic question is what was your reaction when you saw that press release?

Mr. HIRSCH. I was very dismayed by the contents of the press release, and immediately contacted general counsel who had sent it to me, Mr. Horton. Advised him of all of my concerns. I was also accompanied by—

Mr. STEARNS. And the reason you were concerned was because it had the word “cleared” when your investigation did not say that?

Mr. HIRSCH. That was one of our concerns, sir.

Mr. STEARNS. Okay. And did you have conversation with Mr. Scrushy, Mr. Horton or Mr. Davis later that afternoon about that press release?

Mr. HIRSCH. No, sir.

Mr. STEARNS. You got no calls from any of them?

Mr. HIRSCH. Yes, sir. That afternoon on October 29, that is correct.

Mr. STEARNS. I think our staff said when they talked to you, you said you got a call from three of them at 4 p.m. on October 29 asking if there is anything in the—from using that press release as it was already written and passed out?

Mr. HIRSCH. Yes, sir. I was confused as to whether it was that or the following.

Mr. STEARNS. And did you communicate really clearly to them your position that you were upset?

Mr. HIRSCH. Yes, sir.

Mr. STEARNS. Did they go back and change the press release?

Mr. HIRSCH. No. That was not exactly the connotation or the purpose of their call to me. But, in fact, no there were no changes to the press release.

Mr. STEARNS. Okay. Was there reaction from the law firm of Fulbright & Jaworski to this press release?

Mr. HIRSCH. Is the question what was the reaction?

Mr. STEARNS. Yes. What was F&J's reaction to the press release?

Mr. HIRSCH. We advised Mr. Horton, and I advised others, that the press release was unacceptable. We had no control over the issuance of the press release. When, in fact—

Mr. STEARNS. Did you—

Mr. HIRSCH. Excuse me, sir.

Mr. STEARNS. That is good.

Do you know a Mr. Felice Gallant?

Mr. HIRSCH. I do know a woman who is an attorney at Fulbright & Jaworski named Felice Gallant, yes.

Mr. STEARNS. This is Tab 77 from Neil Gold to Hirsch with a cc copy to Felice. This is what he said to you:

"Hal, this is hilarious. Is it a"—and he is talking about the press release. "Is it a parity or is it for real? A few thoughts and questions. One, I did not know we had the power to clear Richard. In fact, our letter says quite the contrary. What is the legal definition of inkling? Is it more like scintilla? Do these idiots realize that 2 months after May 14 is July 14?" And it goes on.

Do you remember that memo?

Mr. HIRSCH. Very much so, yes.

Mr. STEARNS. Okay. Do you agree with that memo?

Mr. HIRSCH. I do not agree with the colorful connotation of that memo.

Mr. STEARNS. No. But I mean content, in terms of the just saying what are we clearing Richard for, because our evidence shows he was not cleared.

Mr. HIRSCH. In fact, sir, we never cleared Mr. Scrushy. I am certain that the staff has seen, and I believe you have seen that our report reflects totally different statements.

What in fact we did do is, I had spoken to Mr. Horton. We advised Mr. Horton of the errors. We had no control over the press. We advised what was wrong with the press release. I believe it is a subsequent email to either Mr.—I know to Mr. Horton, as well possibly copying others and Mr. Gold evidencing in fact that I had contemporaneous conversation with Mr. Horton evidencing or explaining all of those issues.

Mr. STEARNS. Did you threaten to say listen, if you do not change that press, we are going to resign as counsel if a corrective press release were not issued?

Mr. HIRSCH. Yes, sir, we did.

Mr. STEARNS. Okay. And what was Mr. Davis' reaction to the decision concerning the press release?

Mr. HIRSCH. Subsequently after the press release was issued, and it became public, we advised that the press release needed to

be revised to reflect the actual state of what our report had said. And that report, in fact, did not say what the first press release was. The results was that there was a dialog and there was a change by the company, a revised press release was negotiated on the 1st of November and it was issued before the business—the opening of business on November 4.

Mr. STEARNS. Did you ever communicate to Mr. Davis that you felt that this whole press release was being finessed based upon your conclusions and was really a PR?

Mr. HIRSCH. I do not think I ever connoted it in that way, sir. I think what I had—

Mr. STEARNS. But you did tell him?

Mr. HIRSCH. I did tell him bluntly that it was wrong.

Mr. STEARNS. You said, listen, we are all in the same team here. You are trying to finessed this. This is not right. I did not say this. We are going to do a retraction or I am off?

Mr. HIRSCH. I do not think I said in that—

Mr. STEARNS. In those terms, but—

Mr. HIRSCH. But I do not think I said—I know I would have said we are all on the same team. I know that the press release had to be revised. The company was under a Securities Exchange review. We needed to be certain that the public information that was being disseminated was consistent with what we believe was correct. And because that press release seemed to be somewhat inconsistent with our report at the minimum, that we required a revised press release. And the company acceded.

Mr. STEARNS. Okay. Let me just move to document shredding.

Mr. HIRSCH. Yes, sir.

Mr. STEARNS. Did you discover during your investigations that potentially relevant documents to the investigation were shredded in a file room on the fifth floor of the executive office tower?

Mr. HIRSCH. We founded shredded documentation. My staff did. The relevance of the documents were not determined until a time thereafter. But, yes, sir.

Mr. STEARNS. And was the incident reported to the Board?

Mr. HIRSCH. The incident was reported to the Board, sir, yes.

Mr. STEARNS. Okay. And Mr. Scrushy?

Mr. HIRSCH. And to Mr. Scrushy.

Mr. STEARNS. Okay. And what about Mr. Horton, what was his reaction when he was told about it?

Mr. HIRSCH. I had advised 2 days after the day after my—I believe it was 2 days after my engagement, of Fulbright's engagement, I had spoken to Mr. Horton on the telephone and asked him what the document retention policy was at HealthSouth. I was advised, in fact, that there was not one that was consistent with what I needed. So I directed Mr. Horton, or instructed me, to issue a notification to the 50 some thousand employees that every single document needed to be retained in everything except the daily newspapers.

Mr. STEARNS. Well, that sounds like you acted very honorably. I mean, you just sensed something was happened. You immediately said, hey, listen we got to stop this. And so that was good.

And you do not have to answer this, but did you know why this shredding was not mentioned in the October 1, 2002 Board meeting minutes?

Mr. HIRSCH. I have no understanding as to how the minutes were kept, who kept them or anything.

Mr. STEARNS. Okay. Let us go to the shredded documents. Evidently, you were able to get a copy of these shredded documents?

Mr. HIRSCH. We found two bags, sir.

Mr. STEARNS. Yes. Two bags. So we have here in subtab 88 copies of these shredded documents.

Do the shredded documents, even though they are shredded, there appears in looking at them myself that some of the shredded documents contain notations dealing with 1753 and \$175 million. And, in fact, when I looked at this I have got from Richard Scrusby on one of the shredded documents. And I have got \$175 million. In fact, I have got \$175 million, 1, 2, 3, 4—3 times. You know about these.

Mr. HIRSCH. Pretty much so, yes. We found them, sir.

Mr. STEARNS. So if we have shredded documents that indicate that we are talking about 1753, we are talking \$175 million and they have the word Scrusby in it, from Scrusby, I do not know what that means. I guess probably you do not either. And probably it would be difficult to conjecture. But it appears that these shredded documents were about the \$175 million and 1753, and somebody was trying to destroy documents dealing with relevant pertinent information that could apply to this whole investigation you were doing. Could I say that?

Mr. HIRSCH. You can say that, sir. We were—my and our concerns were greatly heightened.

When we found the shredded materials, we told Mr. Horton he had a problem, he needed to send out another memo. There was another document retention memo sent out to the firm, to the employees, the 50 some odd thousand. We then subsequently advised the company that every shredder needed to be sequestered or removed from the premises.

We ultimately, as you have seen I am sure in our report, made tasking recommendations to the Board which specifically included retaining an outfit who could seek to reconstruct these shreds for the purpose of trying to ascertain what was going on.

What you see here, sir, this October 31 memo, was one to the Board subsequent to the Board meeting that I believe was had on the 29th where the Board members were being provided copies of what we had found and asking them for their authority under the tasking instructions or suggestions we had found as to whether they were going to authorize us to retain an outfit to try and reconstruct.

Mr. STEARNS. I will just conclude, Mr. Chairman, and ask this final question to Mr. Hirsch.

Did you feel at this point that the scope of your investigation was being reduced significantly?

Mr. HIRSCH. On October 31, sir? There was certainly an attempt, and the emails I think reflect that the staff has shown me and refreshed me, that there was an effort to indicate that our services had been completed. That as a result of the first four reports that

you have referenced, that our work had been finished. We had a disagreement and believed there was more work to be done.

Mr. STEARNS. Did the Board ever instruct you or anybody to reconstruct these shredded documents? I mean, from what I see here, I mean it does not seem like it is impossible to reconstruct these shredded documents?

Mr. HIRSCH. I am sorry. That it is or is not impossible, sir.

Mr. STEARNS. I think it looks possible to reconstruct these shredded documents. Did the Board ever instruct you and say, look, we see all these very pertinent terms there. Why do you not go ahead and reconstruct the shredded documents?

Mr. HIRSCH. We were persistent and the Board was agreeable. We did retain an outfit named Corefax. They made significant efforts and we have provided, I believe to staff, copies of what Corefax was able to do. In fact, they had large room, little pieces of data. We have photographs of what they were able to reconstruct.

Mr. STEARNS. So the Board never directed you to reconstruct the shredded documents?

Mr. HIRSCH. They authorized us to do it, though, sir.

Mr. STEARNS. Do it.

Mr. HIRSCH. But in fact—

Mr. STEARNS. It was difficult to do?

Mr. HIRSCH. We were told by Corefax they could not do it. As I— with my very limited understanding of shredding—

Mr. STEARNS. Mine, too.

Mr. HIRSCH. Well, I am grateful to know—

Mr. STEARNS. Because we shred documents, and I do not know how you do it.

Mr. HIRSCH. We do not shred documents, sir.

Mr. STEARNS. Yes.

Mr. HIRSCH. But notwithstanding that, apparently if they are shredded once—

Mr. STEARNS. Yes.

Mr. HIRSCH. Life is easier.

Mr. STEARNS. Yes.

Mr. HIRSCH. If they are shredded and crosshatched, it is near impossible—

Mr. STEARNS. The permutations?

Mr. HIRSCH. Right. And apparently the very advanced shredding machines which seem to be located with each photocopier machines, maybe 50 or 60 of them, in the facility that you are speaking of there, crosshatched each of them. And these were, in fact, were a part of those.

Mr. STEARNS. Thank you, Mr. Hirsch.

And thank you, Mr. Chairman.

Mr. GREENWOOD. The Chair thanks the gentleman.

Recognizes himself for another 10 minutes.

Mr. DAVIS. Mr. Chairman.

Mr. GREENWOOD. Yes, Mr. Davis.

Mr. DAVIS. Excuse me for interrupting you. At some point either in your questioning or somebody else's I would like an opportunity to respond to Congressman Stearns' and his references to me, and the exchange that just occurred with Mr. Hirsch.

Mr. GREENWOOD. We will try to do that. We will try to do that. And I suspect that after I ask Mr. Hirsch questions, we will have some more things that you want to say.

Mr. DAVIS. Thank you. And I hope Congressman Stearns will be here to hear me out, and we can set the record straight.

Mr. GREENWOOD. Mr. Hirsch?

Mr. HIRSCH. Sir?

Mr. GREENWOOD. When was the report reviewed with the Board?

Mr. HIRSCH. I beg your pardon, sir, which report? The shredding report?

Mr. GREENWOOD. No, no. The October 21 report?

Mr. HIRSCH. I believe that was on October 22, sir. But I am not certain. But I believe it was the following day.

Mr. GREENWOOD. Okay. Was anyone provided a copy of the report prior to the October 22, 2002 Board meeting?

Mr. HIRSCH. No, sir. I handed it out to the members myself.

Mr. GREENWOOD. Okay. And did Mr. Davis ever ask you to provide him a copy of the report in advance of that Board meeting?

Mr. HIRSCH. Yes, sir.

Mr. GREENWOOD. Okay. Would you look at Tab 57 and if you will begin with Tab 57. And could you identify that?

Mr. HIRSCH. Well, the upper left hand corner of the email of the document evidences that it's an email that would have come from my machine, as my name is on it. It appears to be an email from Lanny Davis to me on October, 17, 2002.

Mr. GREENWOOD. Okay. And he asks you in that email "Can I get a rough draft tomorrow, please?" This is on October 17, 5 days before it was presented to the Board meeting. "You promised I would not have to wait any longer than that. Need more than 1 day to register concerns. Let us talk early in A.M. Hope all is well, etcetera."

How did you respond to that email?

Mr. HIRSCH. I do not recall exactly how I responded. I can tell you the transposition of events if you like, sir.

Mr. GREENWOOD. Go ahead, please.

Mr. HIRSCH. All right. What had occurred is that there was a dialog had where Mr. Davis had requested a copy or the opportunity to see the document in advance. I was very reticent to do so for fear that the integrity of the report might be compromised. Mr. Davis, as I best understood, was responsible for a number of things with regard to the engagement, particularly and including the media issues. I was very sensitized to the media issues and did not want any of my reports, Fulbright's reports, to be disseminated to anybody prior to them going to my client through the Board of Directors.

The result is that I attempted to—advised Mr. Davis that I did not want to give him a copy. Notwithstanding that, a dialog was had by Mr. Davis with myself and myself with my colleagues at Fulbright & Jaworski. And Mr. Davis advised of one thing, one point he made, it reigned true; and that is that Mr. Davis was co-counsel and he may have facts, information or knowledge which might impair or impact upon our report. Mr. Davis had people on the ground doing investigation even before Fulbright began. And

Mr. Davis wanted to be certain that there were not facts that would be in error.

In discussing those issues with Fulbright and myself, I certainly personally concluded that the very last thing I wanted to do is have a report that would go in error.

Ultimately, I agreed to Mr. Davis' request, such that I would read the document to him, which I did. And your staff has refreshed me, as I did not recall, it seems that it was the morning of the 20th, that Sunday. And I had read Mr. Davis and Mr. Goldberg, his associate, the entire report that morning.

I did not thereafter—and it was the final report. There were no changes ever made to the report. The report was finished at that point and in that condition was provided and read to the Board on the 22nd.

Mr. GREENWOOD. Okay. Would you refer to Tab 63.

Mr. HIRSCH. Sixty-three, sir?

Mr. GREENWOOD. Yes, please.

Mr. HIRSCH. Yes, sir.

Mr. GREENWOOD. Okay. Did you get permission from Bill Horton to read the report to Mr. Davis?

Mr. HIRSCH. Yes, sir. That was very important to me. I wanted the company's authority to be able to do what I was doing before I had done it. And my contact with the company was general counsel, Bill Horton. And he gave me that authority.

Mr. GREENWOOD. Now, are these words yours? "We have just finished with an ultimate draft of the report due to the Board on Tuesday. I expect a copy near midnight. Lanny Davis has requested to see and comment on the report in advance. Fulbright will not allow me to transmit a draft, but with your authority as general counsel, I can allow him to read it"—it should say at, I assume, "or in our office tomorrow morning or read it to him. I therefore request your authority to do so."

Mr. HIRSCH. Yes, sir. Typos and all.

Mr. GREENWOOD. And did you in fact read him the report?

Mr. HIRSCH. I read it to him. He was—I do not recall if he was unable or unwilling, or whatever it may have been. I think he was unable to come to the Fulbright offices in DC, so it was agreed that I would read it to him.

Mr. GREENWOOD. Okay. At the top of that email it says—there is an email from you to Bill Horton, dated Sunday, October 20, 2002 at 10:53 a.m. It says "In the process right now and he is happy so far." To whom are you referring there?

Mr. HIRSCH. I am referring to Lanny Davis that Mr. Davis was happy that I was reading it to him. He had wanted me to read it, and he was happy that I was reading it to him.

Mr. GREENWOOD. And did you read the entire report to him?

Mr. HIRSCH. Yes, sir.

Mr. GREENWOOD. Word-for-word?

Mr. HIRSCH. Yes, sir.

Mr. GREENWOOD. Okay. Did he have any comments on the report? Did he identify any factual errors or did he express any concerns or want any corrections made?

Mr. HIRSCH. Your staff asked me that. And the best that I can, you know, reach into the recesses of my mind from that time is

that I do not recall Mr. Davis referencing anything, having concerns other than indicating that he wanted to—I basically recall him saying he wanted to think about it and he would get back to me. But I do not think he had any substantive comments or non-substantive comments, for that matter.

Mr. GREENWOOD. When you read in the conclusion of the report that Mr. Scrushy was present during a Monday morning meeting on July 8, 2002, during which the existence of Transmittal 1753 was referenced, do you recall Mr. Davis registering any response to that?

Mr. HIRSCH. I—as you say that now, I recall Mr. Davis having a reaction, but I cannot replicate the reaction. It was something along the lines of surprise, as best I can describe it.

Mr. GREENWOOD. Surprise? Okay.

And if you would look at 67?

Mr. HIRSCH. Yes, sir.

Mr. GREENWOOD. And at the page, the third page of that, the bottom there is an email from you to Mr. Davis at Patton Boggs, dated October 21, 2002 at 7:25 a.m. So this would be the next day after you read Mr. Davis—

Mr. HIRSCH. I am sorry, sir.

Mr. GREENWOOD. Okay.

Mr. HIRSCH. You said page 3, do you mean page—

Mr. GREENWOOD. Tab 67. I am sorry. Page 2 on Tab 67.

Mr. HIRSCH. Thank you, sir.

Mr. GREENWOOD. Do you see the—

Mr. HIRSCH. I do, sir, yes.

Mr. GREENWOOD. Okay. So this was the morning after you had read Mr. Davis the report. Would you characterize that email for us?

Mr. HIRSCH. I think—I do not know what you mean by characterize. Do you want me to explain it?

Mr. GREENWOOD. Yes.

Mr. HIRSCH. There had been a request that I read the email again or—beg your pardon, the report again or provide it again to other people. And I thought that that was something that might compromise both the integrity of what we had done at Fulbright and possibly, more likely, get the document into the hands of the media or other people than my client before I delivered it. Once I delivered it, they could do as they like.

Mr. GREENWOOD. And did Mr. Davis want Mr. Scrushy to have access to the report?

Mr. HIRSCH. In accordance with this email that appears, yes sir. But I do not have a specific recollection other than what the email says.

Mr. GREENWOOD. And did you know at the time that Mr. Davis represented Mr. Scrushy and the Board?

Mr. HIRSCH. I have subsequently found that I did not know that. When I met with staff, I did not recall when I was apprised of that. As you might expect, I became quite curious because staff was curious. And I found that I was apprised of that on November 8, 2002.

Mr. GREENWOOD. Well, the email says “Despite the issues of propriety when the SEC demands advice as to who had preknowledge of the report before its release, as it always does, do you really

think that it is wise to say that RMS" referring to Richard Scrushy, "was given the opportunity to influence the report. This would undermine all F&G has done."

What made you have concern about the fact that Mr. Scrushy might have opportunity to influence the report?

Mr. HIRSCH. I do not recall why I used the word influence. But my concern is always when anyone sees a report or any document prior to when it is ready to be presented, that there will be a question as to whether or not that person did or had the opportunity to influence the report. My concern is very heightened with regard to integrity. I did not want anyone in hindsight to be able to say that there was an opportunity for someone to influence whether they did or they did not.

Mr. GREENWOOD. Now, did you know at the time that the arrangement that Mr. Davis had was that he would represent the Board and the Mr. Scrushy, and if they became in conflict, that he would then, his allegiance would go to Mr. Scrushy, not to the Board.

Mr. HIRSCH. That is what I spoke to before. Let me be more clear.

Apparently there was an email that went from Mr. Davis to Mr. Scrushy. It was a 4 or 5 page email that was dated September 22, 2002. When we imagined Mr. Scrushy's personal computer in his office, apparently we came to a copy of that document. And that document reflected what you are saying, sir.

I did not see, and I believe that my staff did not see that document until November 8. And on November 8 a copy of that email was sent to me by one of the attorneys in the Fulbright office who had been down in Birmingham and provided it to me. That was the first time that I had seen it.

Mr. GREENWOOD. Okay. For the information of all, we have 7 or 8 votes coming. I did not want to keep this panel here for that length of time. I want to be fair to the gentlelady from Colorado, I want to be fair to Mr. Davis.

So I am going to ask that in the next 10 to 12 minutes, Ms. DeGette, that you do your best to answer—ask questions and if you can, give Mr. Davis an opportunity to say something.

Ms. DEGETTE. You know, it would be a first if I had to answer questions. So I appreciate you letting me ask the questions, Mr. Chairman.

Mr. Hirsch, your firm was originally hired to be independent counsel for HealthSouth special litigation committee, correct?

Mr. HIRSCH. I was told when I entered the middle of a Board, yes.

Ms. DEGETTE. And then when you got down to Birmingham, Mr. Scrushy convened a telephonic Board meeting to hire Fulbright & Jaworski as the defense counsel, right?

Mr. HIRSCH. When I arrived in Birmingham, litigation attorneys for a company apprised me that there was an SEC investigation of the company and they wanted us to handle that. I apprised them that we could not do that if we were—

Ms. DEGETTE. Right.

Mr. HIRSCH. [continuing] in fact to do the SLC

Ms. DEGETTE. Because it would be conflict.

Mr. HIRSCH. Then we could not.

Ms. DEGETTE. Right.

Mr. HIRSCH. In fact could not. And there was a dialog had between litigation counsel who arrived at the facility and Mr. Scrushy that they wanted us to take on the other engagement, which I said that we would do——

Ms. DEGETTE. But, so the answer is——

Mr. HIRSCH. Yes. But I said——

Ms. DEGETTE. Yes.

Mr. HIRSCH. [continuing] we would do that in the event that the Board authorized it.

Ms. DEGETTE. Right. And that is what you did, right?

Mr. HIRSCH. That is correct.

Ms. DEGETTE. So do you know did the special litigation committee ever hire anybody to do the job you were originally contacted to do?

Mr. HIRSCH. I do know they did that.

Ms. DEGETTE. I am sorry?

Mr. HIRSCH. I do know that they did that.

Ms. DEGETTE. Did they?

Mr. HIRSCH. They did, yes.

Ms. DEGETTE. Who did they hire?

Mr. HIRSCH. I believe the name of the first, I do not know the gentleman's name, I do not recall, but it was Balch & Bingham. They were retained. They were, I believe, an Alabama firm. And they were retained to represent the committee. And they did do that.

Ms. DEGETTE. Right. And did they do anything, do you know?

Mr. HIRSCH. I do not know what they did.

Ms. DEGETTE. Did they ever come up with a report?

Mr. HIRSCH. I met—I met telephonically with the gentleman from Balch & Bingham on three occasions, I believe they told staff, and I met with his special litigation committee in person with him by telephone for an extended period at a particular time. I gave him the information——

Ms. DEGETTE. But you do not know if they ever did anything?

Mr. HIRSCH. I do not.

Ms. DEGETTE. Thank you.

Mr. HIRSCH. I know that we provided——

Ms. DEGETTE. I am sorry.

Mr. HIRSCH. I am sorry.

Ms. DEGETTE. We have to go vote.

Mr. HIRSCH. Certainly.

Ms. DEGETTE. Hang on 1 second.

Mr. DAVIS. Just to be perfectly fair, if you are going to vote and there is has been 10 or 12 minutes of conversations about me, I should have an opportunity to respond.

Mr. GREENWOOD. We are in discussion about that.

Ms. DEGETTE. Mr. Davis, you are so right.

Mr. GREENWOOD. We are going to do that. And——

Mr. DAVIS. This is very unfair that I have no opportunity to respond to 10 or 15 minutes of references to me that are not entirely accurate.

Mr. GREENWOOD. Actually, if I may, Mr. Davis?

Mr. DAVIS. All right.

Mr. GREENWOOD. Okay. We are in discussion right now about trying to be fair to you. And it is our conclusion that if you would like additional opportunity, the only way to manage that will be to come back in about an hour and you will have plenty of time to—

Mr. DAVIS. Well, how about giving me 5 minutes right now before you leave to vote? Because there are members of the media here who have—

Ms. DEGETTE. Go ahead. Because I cannot come back. Just go ahead. Go.

Mr. DAVIS. Well, Madam Congresswoman—

Ms. DEGETTE. Go.

Mr. DAVIS. It is only fair—

Ms. DEGETTE. Mr. Davis, 5 minutes. It is yours.

Mr. DAVIS. Mr. Chairman, may I?

Mr. GREENWOOD. Yes, sir.

Mr. DAVIS. I will try to be brief, and I apologize—

Ms. DEGETTE. Go.

Mr. DAVIS. My first comment is that I take responsibility for the word “cleared,” because I believed that that was a reasonable inference in the Fulbright report. It is not correct that that word “cleared” was not circulated as a draft press release throughout the day, including circulated to Fulbright & Jaworski.

Second, I included in that press release the entire last paragraph that included all of the Fulbright’s caveats that you cannot prove are negative.

Also, never having heard any objection to the word “cleared” in exchanges of emails throughout the entire day, I would never have sent a press release without the approval of all of the counsel involved, and that is the position that I am taking.

Second, regarding the reason that I asked for the report to be read ahead of time, I simply ask you again to look at Tab C. I only wanted ahead of time advance notice so that I could prepare for the media and address whether there were any open issues.

And third, most importantly, the shredding issue and the July issue was not addressed in the first draft and, in fact, I did not hear the sentence about shredding read to me over the phone until it was read to the full Board. Because it was read, we then asked Fulbright go back ahead of time. There was absolutely no intention to influence the results of that report.

Thank you, and I am sorry for interrupting, Madam Congresswoman.

Ms. DEGETTE. Mr. Chairman, I would also—what I had originally intended to do was ask unanimous consent that Mr. Davis could supplement his answer in writing for the committee. Because I also believe that it is very important that he be given an opportunity to respond to the allegations. And so I would ask that.

Mr. GREENWOOD. This is what I would propose—

Ms. DEGETTE. If that is all right with him.

Mr. DAVIS. Thank you.

Mr. GREENWOOD. I would propose we have 8 minutes and 42 seconds to the vote. We will need about 3 of those minutes to get to the floor.

Ms. DeGette, you have 5 minutes additional if you would like. And then I am going to propose that we will reconvene in approximately 1 hour.

I would ask if there is anyone on the panel who cannot be back here in an hour?

Ms. DEGETTE. I cannot be here. I will send someone back over.

Mr. GREENWOOD. Okay. In that case, Mr. DeGette, do you wish to take time now?

Ms. DEGETTE. Mr. Chairman, I have no further questions.

We have been here. It has been a long day. I want to thank the panel for coming. And once again, I would say, you know, there is 5 minutes. If Mr. Davis wants to talk now, if he wants to supplement his answer in writing, I really—I think we have got the gist of it. And I am, frankly, done.

Mr. DAVIS. Well, if the Madam Congresswoman will allow me, in a few more minutes I only have a couple of more points that I would like to make, but I did not want to crowd her time.

Mr. GREENWOOD. Here is what we are going to do. We are going to be fair to you, Mr. Davis. We are going to be fair to the process, which means that we are not going to just give you the last word and then walk away from that either.

So, regrettably, because everyone's schedule is impacted by this, we will recess and we will return in approximately 1 hour at the conclusion of the next six votes.

The committee is in recess.

[Brief recess.]

Mr. GREENWOOD. The subcommittee will reconvene with apologies to all of you for the interruption.

The Chair will recognize himself for 10 minutes.

And, Mr. Davis, I am going to give you an opportunity to make things as clear as you can, but I am going to do it by asking you some questions rather than just the microphone over to you.

Mr. DAVIS. I thought you were talking to me.

Mr. GREENWOOD. Welcome, Mr. Davis.

Prior to the break, Mr. Hirsch testified that he read you the entire Fulbright report over the phone. And I am going to ask you to turn to Tab 63. You will find there an email from Mr. Hirsch to Bill Horton. And this email, October 20, Mr. Hirsch responds to Mr. Horton's statement to make arrangements to review the draft with you. Mr. Hirsch replies: "In the process right now, and he is happy so far."

Mr. Hirsch contends that this was written contemporaneous with reading you the report. During our staff interview with you, staff specifically asked you whether Mr. Hirsch had read the report to you. You told staff that Mr. Hirsch had paraphrased the last two sentences of the report for you. In your statements to the committee today you have suggested that you heard more than a paraphrased last two sentences.

So, will you please state for the record what Mr. Hirsch read to you on the phone?

Mr. DAVIS. Yes, am I am happy to clarify that.

First of all, I appreciate the fact that Mr. Hirsch and I agree that I did not attempt to alter any conclusions and he had too much integrity and independence to alter any conclusions, and that is the

central issue for me that I never attempted to influence the truth coming out here. I did everything I could to get the truth out.

On the issue of what happened on that Sunday morning, reasonable memories can differ. Adam Goldberg, my young colleague and I, were trying to convince Mr. Hirsch to read us the entire report so that we could prepare for a press plan, not to influence the outcome.

It is my best recollection that he read the last paragraph, not the last two sentences, of the report and paraphrased was in fact a report that was about the process of the investigation; how many witnesses were interviewed, how many documents were reviewed. But that only the last paragraph was what I remember him paraphrasing or reading which led to the last two sentences comment that I made—

Mr. GREENWOOD. Let me interrupt you there.

Mr. DAVIS. Yes.

Mr. GREENWOOD. If you turn to Tab 63 and 64, you will see memos from Mr. Hirsch. The first, on Sunday October 20 at 10:53 a.m. went to Bill Horton. "In the process right now, and he is happy so far" that was in response to Mr. Horton's email which said "Please make arrangements with Lanny to review the draft."

On Tab 64 we have another email from Mr. Hirsch, this is to Tom Dowdel on the same day at 12 p.m., and he says I am on with Lanny, all is well. I need 15 minutes.

The separation there is an hour and 7 minutes and he still seemed to need 15 minutes. If he was on the phone with you all of that time, one would assume that he would be able to read more than the last couple of sentences?

Mr. DAVIS. We were talking about a lot of things during that telephone. It was a Sunday morning. We were talking about the press implications, the Board meeting and he was trying to paraphrase the earlier sections of the report. So the entire conversation, and Adam Goldberg and I tried to remember this before my staff meeting, took about an hour. But that hour was not filled—that hour was not filled—

Mr. GREENWOOD. You said in answer to my previous question that your recollection is that Mr. Hirsch read you the last couple of sentences?

Mr. DAVIS. He paraphrased almost verbatim by reading, but said he was paraphrasing the entire last paragraph called on the conclusion. And then—

Mr. GREENWOOD. He paraphrased other sections of the—

Mr. DAVIS. Paraphrased the parts of the report before the conclusion that were essentially process about how many people were interviewed and how many documents were reviewed.

Mr. GREENWOOD. Now let me return to you, Mr. Hirsch, because I believe you responded earlier to a question that, I think it was I who posed, which was I thought your response was that you read the entire report to Mr. Davis, word-by-word. Is that correct?

Mr. HIRSCH. That is my recollection, sir, yes.

Mr. GREENWOOD. Okay. And it's an extraordinary different set of recollections. Because reading a report word-for-word is a time consuming and lengthy process. And is it your recollection, Mr. Hirsch, that you began to read that report and were you interrupted by Mr.

Davis during the reading of that report, or did he allow you to read the entire report word-for-word and then discussion commenced after that?

Mr. HIRSCH. My recollection is that I read the report from beginning to end, sir.

Mr. GREENWOOD. Mr. Davis, how do you reconcile that?

Mr. DAVIS. I had a different recollection. I do not reconcile it. And I can only say that the sentence—

Mr. GREENWOOD. It strikes me as impossible for two people to recollect that differently. In other words—

Mr. DAVIS. One of us is right.

Mr. GREENWOOD. In other words, one of you is right, and I dare say, telling the truth. The fact of the matter is reading a report word-for-word is a laborious thing to do and it hard for me to imagine someone doing that—not doing that, instead just paraphrasing some sections and recollecting a word-by-word verbatim reading of the document. And it is also very difficult for me to imagine having someone having a report read to him word-for-word and not being able to recollect that process.

Mr. DAVIS. Well, Mr. Chairman, you are addressing that comment to me.

Mr. GREENWOOD. Yes.

Mr. DAVIS. I would assume you would address the same comment to Mr. Hirsch. We have different recollections. It could be an honest failure of memory, as much as anything else.

I have a clear recollection that Mr. Hirsch read me the conclusion, but said I am going to paraphrase it and then read me the whole last paragraph and then summarized the earlier parts of the report. That is my clear recollection.

Mr. GREENWOOD. Hal Hirsch, would you turn to item 61, please? And this is a memo that apparently you sent to Hal Hirsch on the Saturday night before, at 7:14 p.m. I am sorry. It was from Hal Hirsch to you. And he says “Call in the morning when you wake up and we can go over it line-by-line on the phone.” That is the HealthSouth report. Do you remember receiving that?

Mr. DAVIS. Yes, I do.

Mr. GREENWOOD. Okay. And so we have got him saying to you call me tomorrow morning, I will read the whole thing line-by-line. We have got him sitting here saying and I did in fact read it to him line-by-line, word-by-word. And you are saying that all you recollect was a paraphrasing of a small portion of the report?

Mr. DAVIS. I actually said I have a clear recollection that he did not read it line-by-line, but he did the last paragraph virtually as I saw when I got to Alabama, and he actually read the entire report to the Board that the final paragraph was virtually the same.

But there was a sentence that I did not know about until he read it to the Board on October 22. And that sentence was the sentence pertaining to shredding. That is the first time that I knew that there was a sentence about shredding in the report. I did not even know that on Sunday when we discussed the contents of the report.

Mr. GREENWOOD. Mr. Hirsch, do you recall reading that statement, that sentence to Mr. Davis?

Mr. HIRSCH. That sentence, not specifically, sir. I recall reading the report. That is all I recall, sir. I do not recall any other great moment of reading the report, of that conversation.

Mr. GREENWOOD. Is it unusual that you would have read this report line-by-line to an attorney representing a client?

Mr. HIRSCH. I had read all of the prior read—I read the prior report to the Board line-by-line. When I met with the Board on October 22, I read this report line-by-line, even though I gave them a copy. The same thing with the report on October 29.

So, it was not unusual or out of the ordinary in this circumstance. This is the best that I can recall, sir.

Mr. DAVIS. Mr. Chairman, it may help for me to add that I would have liked to have the whole report read to me from beginning to end that Sunday morning, because I wanted to prepare for a press plan. And since both—since both Mr. Hirsch and I agree on the most important point, which my email Tab C states, I had no intention of effecting Mr. Hirsch's conclusion.

Mr. GREENWOOD. Then turn to Tab 57.

Mr. DAVIS. And I believe that he agrees with me on that.

Mr. GREENWOOD. Tab 57 is an email from you to Mr. Hirsch on October 17. So this is 3 days prior. And in that email you say "Can I get a rough draft tomorrow, please. You promised I would not have to wait any longer than that. Need more than 1 day to register concerns. Let's talk early on in A.M., etcetera."

So you just a moment ago said I had no intention of altering a report.

Mr. DAVIS. To influence the conclusions of the report. And I said in my opening statement, Mr. Chairman, what my concerns were, which turned out to be correct.

My concerns were that there would be open issues unresolved, that would raise more questions in the media and in the public markets. And it turned out after Mr. Hirsch read the report to the full Board, including the sentence that I had not heard before about shredding, my reaction was before we release this report, we need a further investigation of the shredding and a further investigation of the July meeting. That is what I mean by the word "concerns," and only that, sir. Not substantive, and not about effecting conclusion, which Mr. Hirsch and I both agree I did not do.

And I do hope that you will reread, Mr. Chairman, Tab C, which is my email of October 21. Mr. Stearns suggested by pointing to the word "influence" in the email that he read, that Mr. Hirsch used the word I was possibly trying to influence. This email came 30 minutes after the email that Congressman Stearns read. And I was responding to Mr. Hirsch's legitimate concerns on the appearances. And so I said this was me and Mr. Deaver and Mr. Powell wanting to hear the report read ahead of time without influencing or altering the report.

And here is what I said at Tab C. "If it is in final form—and that would be the understanding BEFORE you read—final form, advance reading has no impact on Fulbright credibility to the SEC or anyone else." That's for me, the most important email to persuade Mr. Hirsch it was okay to read me something ahead of time if I did not try to influence the outcome, other than completing open

issues that might be raised because they had not been finally resolved.

Mr. GREENWOOD. Mr. Hirsch, would you turn to Tab 93, please.

Mr. HIRSCH. Yes, sir.

Mr. GREENWOOD. Could you identify that document?

Mr. HIRSCH. No, sir. I mean, I can tell you that it appears to be some Jason Hervey's email system from Richard Scrushy, dated Friday, November 8 at 9:15:02 to Jason Hervey, subject: Re thank you. I have not seen it before, sir, so I cannot otherwise identify it.

Mr. GREENWOOD. Well, the one below it.

Mr. HIRSCH. Oh, I see. The one below it. Yes. Thank you. Thank you. Yes.

Okay. That is an email from me to Richard Scrushy, sir.

Mr. GREENWOOD. Okay. Now that says in your email, and that was written on Friday, November 8, 2002, it says, I will read a section of it, it says "That is because Lanny Davis filters everything that you hear. Ever wonder why he badmouths all your people, including officers, lawyers and new directors? The billing issues arose because Davis advised that he would determine how much and if we got paid. From the start, Davis has tried to use the reviews as media props, not as you had described, to find out the truth. If they were used as corporate America uses them and the SEC views them, then your release and media statements would have said something like Scrushy unaware of 1753 when he sold the stock. That is what we said."

Now, can you explain what you meant when you wrote that?

Mr. HIRSCH. This email was sent to Richard Scrushy because I was somewhat frustrated at the—from the events of the first press release, the need for the second press release and at this same time about the issues that related to the engagement, whether or not we were finished, we were not finished. Our primary engagement was the CMS work, the Transmittal 1753. These securities were secondary. Richard Scrushy's stock transfers were tertiary.

It was important that we working for the company were allowed to finish the CMS work. It was important that our work not be filtered by anybody, and I was very concerned with regard to the media's potential influence in what we were doing and the word getting out differently than what we had undertaken. So I wrote this email.

Mr. DAVIS. May I comment, Mr. Chairman?

Mr. GREENWOOD. Yes. Please do, Mr. Davis.

Mr. DAVIS. Thank you.

I think Hal Hirsch did an outstanding job for this company. And I think he did it under very, very difficult circumstances.

Mr. GREENWOOD. Please bear with us.

I am sorry, go ahead.

Mr. DAVIS. I think Hal Hirsch did an outstanding job for HealthSouth and wrote a report not under anybody's influence with a high amount of integrity.

We had a very difficult time with hurt feelings on both sides about the press release that was issued, which led to a revised press release. After that very difficult time, and I believe this email

was written during that time period, I felt that our assignment was over and that it was up to the SEC to continue the investigation.

On November 6, 2 days before this email, at Tab D to my statement I wrote an email to Mr. Hirsch in which I said "Richard Scrusy has instructed me to inform you that, other than Peter Unger, who is the SEC attorney, that you will do no further work for HealthSouth." "I have advised Richard that with the investigation regarding himself completed," remember we had sent everything over to the SEC and waived attorney/client privilege including all the documents, "that we will continue to fully cooperate with the SEC, and therefore" it is the SEC that should continue, "we do not need Fulbright services any longer." Now, some months after this unfortunate hurt feelings period of time for both of us, Mr. Hirsch and I broke bread, he invited me to his son's bar mitzvah. I have the greatest respect for him. And these hurt feelings and these harsh statements have to be viewed in the context of both of us being under a lot of stress at the time.

Mr. GREENWOOD. Anything you have, Mr. Hirsch?

Mr. HIRSCH. I think the answer is that this was not the result of hurt feelings, sir. This had nothing to do with hurt feelings. This was a result of my frustration over the fact that I was trying to represent a client. I was trying to get a report and all the fact, maintain the integrity of what we were doing, get the information out to the world and the world would be first to our client, the Board and second to whomever the Board wanted to give it to.

I was trying to go, as the email said, to go directly to the company, to speak directly to Mr. Scrusy. We have a voluminous number of emails which led up to this, as you have seen. And I was seeking only to get the information done and the report completed.

Mr. GREENWOOD. All right. We are going to pursue one line of inquiry with Mr. McGahan, so you do not feel that you have come here for no good reason.

And I want you to turn to Tab 15, please, sir. Do you have that document? Okay. This is an email from a Roderick O'Neill to you from March 15, 2002. Could you tell us what the meaning of this email is?

Mr. MCGAHAN. Yes, sir. He is indicating to me that certain officers of HealthSouth have intentions or desires to buy into a healthcare we called First Cambridge.

Mr. GREENWOOD. Define the REIT. It's Real Estate Investment Trust?

Mr. MCGAHAN. Yes, sir.

Mr. GREENWOOD. Okay. All right. And what else is this telling you about who would be the investors in this?

Mr. MCGAHAN. Richard Scrusy's daughter, Bill Owens, Bill Horton, Tadd McVay, Weston Smith, Richard Davis and Jason Brown, all of whom are officers of HealthSouth or their designees.

Mr. GREENWOOD. Okay. Would you turn to Tab 13 then? Okay. And would you identify that document, please?

Mr. MCGAHAN. This is a document from Ray Garson, who is a fixed income analyst to two people who work in the healthcare investment banking group, regarding this original loan.

Mr. GREENWOOD. Okay. And if you look at the third, I guess, paragraph there it says "Need to add transaction rational. Why is

HRC selling assets below market or alternatively why is HCI setting rents so low." Okay. And do you know what the answer to those questions are?

Mr. MCGAHAN. No, I do not.

Mr. GREENWOOD. It says we need—further down, three more paragraphs down it says "Does HRC management or related parties own part of Cambridge or HCI." Do you see that?

Mr. MCGAHAN. I do see that.

Mr. GREENWOOD. Do you know why he would want to know that?

Mr. MCGAHAN. I think he would want to know that because that would be a normal due diligence question when making a loan to a company.

Mr. GREENWOOD. Why do you not explain to us what you know about what was going on here in terms of the loan, what the purpose of the loan was and what this real estate investment trust was all about.

Mr. MCGAHAN. Okay. My understanding of First Cambridge was that it was a group of real estate executives that were forming a company to form a healthcare REIT. And I—

Mr. GREENWOOD. Real estate executives, are you including Scrusby's daughter and so forth?

Mr. MCGAHAN. No, sir.

Mr. GREENWOOD. Okay. Go ahead.

Mr. MCGAHAN. These executives I met, I believe in the summer or fall of 2001. And the next I heard of this transaction was in December when Mr. O'Neill informed me that they were interested in buying some healthcare properties from HealthSouth to start this healthcare REIT, to start this company.

I gave him the go ahead. I thought this was a group of experienced executives and that they were going to be successful, I hoped. They had said that we would have future investment banking business.

Mr. GREENWOOD. And why would HealthSouth guarantee their loan?

Mr. MCGAHAN. Well, this was—they would guarantee the loan because—in order to the healthcare REIT started. Because we would be extending credit to the healthcare REIT and they would do a sale lease back—

Mr. GREENWOOD. Did HealthSouth have a financial interest in the REIT?

Mr. MCGAHAN. Our understanding, and again this is what people told me at the time, was that they did not. And we were told in December 2001 when this transaction was funded, that they did not have an interest.

Mr. GREENWOOD. Did it strike you as appropriate for a publicly held company to guarantee a loan which would go on their books, and yet have no potential to benefit from the profits of the REIT?

Mr. MCGAHAN. Well, I thought that they would have a benefit of the REIT, not the profits of the REIT. Healthcare REIT business, there is about 10 or 11 companies out there who are healthcare REITs, all of which were started originally—almost all of which were started by healthcare providers.

So Universal Health has a healthcare REIT, which they do not own the substantial portion of it. National Medical Enterprises

started a REIT, and on and on. And the benefit to those provider companies is that they have a financing company that knows them and works closely with them, and knows their properties, etcetera. So it is an established practice, essentially, that healthcare providers have started healthcare REITs. And those have been very successful companies over the years.

Mr. GREENWOOD. Okay. On Tab 15, going back to this email, it says "I want to make sure we are doing nothing wrong on the HealthSouth REIT. This is the current owner of REIT. No one has put any money in and they want to designate ownership to a significant other, i.e. a wife, daughter, etcetera. Do you think there will be a problem with this when and if they go public?" And then the designation of percentage of ownership would be Richard Scrushy's daughter 20 percent, Bill Owens 10 percent, Horton 5 percent, Tadd 5 percent, Weston 5 percent, Richard Davies 3 percent, Jason Brown 1 percent, etcetera.

Why would you think that Mr. O'Neill would have a concern about the propriety of this?

Mr. MCGAHAN. Well, I thought it was also a very bad idea.

Mr. GREENWOOD. You thought it was a bad idea?

Mr. MCGAHAN. Yes.

Mr. GREENWOOD. And why was it a bad idea?

Mr. MCGAHAN. At this time in March 2002 there were two other companies, MedCenterDirect and Source Medical, of which the senior management of HealthSouth had some equity ownership interest. They were under—shareholders had concerns about these sorts of arrangements, and I thought that it would be a very bad idea to startup or have these executives invest in this company, and I expressed—

Mr. GREENWOOD. But why was it a bad idea?

Mr. MCGAHAN. Because the senior executives were under pressure from their shareholders due to the fact of the perception of conflict of interest of owning shares in a company that was doing business with HealthSouth. And so I thought that would—to add to that would be not a very smart thing.

Mr. GREENWOOD. Yes. Now, they had done something similar to this for the company called Capstone, had they not?

Mr. MCGAHAN. Back in the 1990's.

Mr. GREENWOOD. And were you involved with that?

Mr. MCGAHAN. Not originally, no. But later on—

Mr. GREENWOOD. Eventually?

Mr. MCGAHAN. Yes.

Mr. GREENWOOD. And who profited from that enterprise?

Mr. MCGAHAN. Well, that company, from what I recollect, went public and in the low teens, had dividends of around 10 percent per year for 4 or 5 years and was sold in the high teens. There was also executives from the HealthSouth, to your point, that had an equity ownership in that company as well. So all the shareholders profited.

Mr. GREENWOOD. And made millions of dollars, as a matter of fact, is that not right?

Mr. MCGAHAN. I believe so, yes.

Mr. GREENWOOD. Mr. Scrushy made millions of dollars as well?

Mr. MCGAHAN. I believe so, yes.

Mr. GREENWOOD. Okay. And did you think that was a bad idea as well?

Mr. MCGAHAN. I thought that times had changed.

Mr. GREENWOOD. Because of the different expectations that the stockholders might have?

Mr. MCGAHAN. I think that the stockholders in the equity markets and what they expected out of HealthSouth in March 2002 was much different than it was in the—

Mr. GREENWOOD. Did you share your view with others that you thought it was a bad idea?

Mr. MCGAHAN. I did.

Mr. GREENWOOD. To whom did you express that?

Mr. MCGAHAN. I expressed it to Mr. O'Neill and to Mr. Leder internally. And then I called HealthSouth and spoke with Mr. McVay, and then Mr. Owens, and then Mr. Scrusby.

Mr. GREENWOOD. Was the REIT ultimately formed by those individuals on the memo, on the email?

Mr. MCGAHAN. I am not sure. I expressed my concerns to Mr. McVay. And then I further expressed, because he was principally working on this transaction, he said he had heard me. But then I went over his head and talked to Mr. Owens and Mr. Scrusby. And they ultimately told me that they agreed with me.

Mr. GREENWOOD. Did you think that using significant others was a way to hide the ownership of the HealthSouth executives?

Mr. MCGAHAN. I did not think that they were trying to hide that. I thought that the entire thing was a bad idea, that included.

Mr. GREENWOOD. Okay. So was the REIT ultimately established?

Mr. MCGAHAN. What ultimately happened with this company was it was originally funded in December 2001. This memo or this came to our attention in March 2002. We expressed that it was not a very good idea. We do know also that in—the loan was ultimately paid off and this transaction was unwounded, and the properties went back to be owned by HealthSouth.

Mr. GREENWOOD. Were you aware of the fact that the company's auditors did not disclose the guarantee in the company's audited financial statements?

Mr. MCGAHAN. I was not personally aware of that at all until later.

Mr. GREENWOOD. When did you become aware of it?

Mr. MCGAHAN. In preparation for this. Since I left UBS.

Mr. GREENWOOD. Preparation for this hearing?

Mr. MCGAHAN. Yes.

Mr. GREENWOOD. Did you know that the loan guarantee was extended for 4 days by UBS with the condition that CRC agreed with the 4 day extension and expressed concerns with the fact that the loan guarantee had not been reported and the associated potential reputational risk to UBSW?

Mr. MCGAHAN. I did know a part of that, the extension. The other part of it I am not sure that I did.

Mr. GREENWOOD. Did you know that they required that it be disclosed in the 10k?

Mr. MCGAHAN. My understanding that there was—from what I remember, was that there were conversations between people at

UBS and the company about the disclosure and to make sure that it was an appropriate disclosure that HealthSouth was making.

Mr. GREENWOOD. Why do you think UBS agreed to this being done as a side deal and kept off the books?

Mr. MCGAHAN. I think that just in terms of the structure of the transaction, the original intent of the transaction was to form a healthcare real estate investment trust that would then go out and get other properties. The idea was that they would get \$150 or \$200 million of other properties in addition to these \$80 million from HealthSouth and would go on and become a successful real estate investment trust, just like the others.

It became apparent—and the only way to construct a company like that is to do it the way that it was done. It became apparent some time in 2002 that they were not going to get these properties. It was going to be very difficult for them to do so. That—and that this company really was not getting off the ground.

Mr. GREENWOOD. Well, why would they want it off the books?

Mr. MCGAHAN. Why would they want—I am sorry, sir?

Mr. GREENWOOD. The loan guarantee off HealthSouth's books?

Mr. MCGAHAN. My understanding was that this was a normal healthcare sale lease back transaction. I was not aware at the time of the loan what was going on. My understanding was that there was discussion between people at UBS, not myself, and the company about accounting for the loan. And it was represented to the UBS people that this was an immaterial amount, it was an \$80 million loan in a context of a \$3.4, \$3.5 billion debt balance sheet. And it was an immaterial amount.

Mr. GREENWOOD. So the justification for not putting it on the books was that it was immaterial?

Mr. MCGAHAN. No, that this was a sale lease back transaction. It was being guaranteed by HealthSouth. There was some discussion between the UBS professionals and the company about how it was going to be accounted for. And it was represented, I am told, to the UBS people that the HealthSouth folks had had discussions with their auditors and that this was going—that they were comfortable in the way that this was going to be accounted for.

Mr. GREENWOOD. Well, and theoretically then if you had a company of \$3 or \$4 billion size, if you take money off the books in \$80 million increments it is de minimis, and therefore you do not have to report it. Would that be your reasoning?

Mr. MCGAHAN. Again, you know, I think that obviously I think your point is that if you take \$80 million that they add up. But this was one transaction and that it was ultimately unwound and the properties went back to HealthSouth and the loan was repaid.

Mr. GREENWOOD. Okay.

Mr. CAPEK. Sir? Sir? If I may?

Mr. GREENWOOD. Mr. Capek?

Mr. CAPEK. When you look at the sale lease back transaction, you know for the \$80 million to be going away or coming off of the books, when analysts calculate covered ratios and whatnot, you do look in the footnotes for the REIT. Remember they are still REITing. So we do capitalize the REIT expense and consider that debt and add it back.

So even though the \$80 million was going away in this example, there would be REIT that we are capitalizing and adding back to the total debt—

Mr. GREENWOOD. But the shareholders would not have been aware of that, would they?

Mr. CAPEK. Well, disclosed in the footnotes of the annual report, you do have the future REIT obligations, so they would be aware of that obligation. Not the loan—the loan going away, but the obligation of the REIT.

Mr. GREENWOOD. Okay. I think 9 hours should do it.

I want to thank all of our witnesses. I thank you for indulging us with this extra time we need for the break.

Oh, Mr. Walden, I am sorry. Nine hours is not enough.

The Chair recognizes the gentleman from Oregon for—I apologize for not noticing you were here.

The gentleman from Oregon is recognized for 10 minutes.

Mr. WALDEN. Thank you, Mr. Chairman.

Mr. McGahan, you were in charge of this account, is that correct?

Mr. MCGAHAN. I was the coverage officer.

Mr. WALDEN. You are a coverage officer? Mr. Lorello, what role did you play in this account?

Mr. LORELLO. I run the healthcare group, and this was one of our clients.

Mr. WALDEN. Okay. After Bill McGahan joined Salomon and Smith Barney and became the HealthSouth coverage officer, to what extent though were you involved with HealthSouth and its transactions?

Mr. LORELLO. Starting in the mid-1990's, I would be invited to annual Board meetings. And what attend those meetings along with Mr. McGahan. And perhaps once a year would attend a meeting down in Birmingham.

Mr. WALDEN. Mr. McGahan, how often did you report to Mr. Lorello on HealthSouth issues?

Mr. MCGAHAN. Periodically when I would see him in the office and when there was something to talk about.

Mr. WALDEN. When there was something to talk about, does that mean like every time there was something to talk about you fed back to Mr. Lorello?

Mr. MCGAHAN. Mr. Lorello would keep track of the pipeline of transactions and I would keep him updated on things that were being contemplated or other transactions that were coming down the pike. If there was also any significant items that would come up, I would keep him informed. But it was periodically. I covered about a 100 healthcare companies and so I would keep him informed—

Mr. WALDEN. I see.

Mr. MCGAHAN. [continuing] on those as things were going on.

Mr. WALDEN. Okay. Could you turn to Tab 34, please? This is an email chain from March 6 and 7 regarding an email from Mr. Scrusby having the subject line "To hell with you guys." Do you recognize this message?

Mr. MCGAHAN. Tab 34?

Mr. WALDEN. Thirty-four, sir, yes.

Mr. MCGAHAN. Yes, sir.

Mr. WALDEN. Can you please read for the record Mr. Scrushy's message and then explain to us what Mr. Scrushy is so angry about?

Mr. MCGAHAN. The original message?

Mr. WALDEN. Yes, please.

Mr. MCGAHAN. This is from Mr. Scrushy to me. "I will put up the money myself. Please call Ben and tell him that I will put up the \$24 million personally. Cannot believe you guys are doing this. I guess you guys are breaking up the 20 year relationship, Ben will understand us moving it all somewhere else. We will come back strong and kick butt again. Thanks for the help over the years. We had some good times. Richard."

Mr. WALDEN. Okay. And then what was your response to that?

Mr. MCGAHAN. To Richard, "I will get it done. I promise. Do not wash us away yet. I have talked to Bill and Tadd and tried to call you, and I am all over it. I will call you in the morning with it being done."

Mr. WALDEN. Okay. And that was your response to Mr. Scrushy, right?

Mr. MCGAHAN. Yes.

Mr. WALDEN. And then you forwarded that on to——

Mr. MCGAHAN. This was Mr. Ryan.

Mr. WALDEN. That is right. And then——

Mr. MCGAHAN. I think I also informed Mr. Lorello that through an email forward.

Mr. WALDEN. And I was going to refer to that one, too, which is Tab 31. Could you read your comment?

Mr. MCGAHAN. I think that is to Mr. Leder.

Mr. WALDEN. Yes. I am sorry. To Mr. Leder.

Mr. MCGAHAN. "Just to fill you in what I got. Please get this done ASAP."

Mr. WALDEN. Okay. And Mr. Lorello is copied on that as well?

Mr. MCGAHAN. I believe, yes.

Mr. WALDEN. Yes. Along with Roderick O'Neill.

And that was at what time, again, you sent that?

Mr. MCGAHAN. Around 5:14 p.m.

Mr. WALDEN. 5:14. Four minutes later on under Tab 32 you sent a direct email to Mr. Lorello.

Mr. MCGAHAN. I guess.

Mr. WALDEN. You want to read that one, sir?

Mr. MCGAHAN. Yes, sir. "I hate my job. I resign. Go jump off a bridge."

Mr. WALDEN. We have all had those days.

The only question I have is was the reference to you jumping off a bridge or suggesting someone else should go jump off a bridge?

Mr. MCGAHAN. I am not sure.

Mr. WALDEN. You are not?

Mr. MCGAHAN. I think it was Mr. Lorello.

Mr. WALDEN. Should go jump off a bridge?

Mr. MCGAHAN. Yes.

Mr. WALDEN. Why?

Mr. MCGAHAN. I was just—I just had a bad day. When we had a client that was requesting a loan and I was struggling with it,

and it is a very pressure filled environment. So, I was expressing my frustration with my work.

Mr. WALDEN. And I want to get to what the source of that frustration might have been. If you could turn to Tab 26, please. This is a Commitment Committee meeting concerning the proposed loan to Source Medical Solutions, Inc.

Mr. MCGAHAN. Yes.

Mr. WALDEN. Which on page 48 a Mr. Baudin says "Yes. I am sure what I am looking here at is—I am concerned about dealing with these entities. I do not think we have got a full transparency on the—on Source Medical. I do not like the fact that we have got management who have been owning shares in this and now donating them to charities and so forth. I would not trust Scrusby, Rod, further than we can throw him. I do not think this company management has been that transparent with us in the past."

And then a Chris Ryan responds "But that is true with both entities."

And Baudin replies "Yes."

Chris Ryan replies "Right. So what I mean, I am just—why would you rather in 2007 4 years than an 2003 1 year."

Something from Baudin, "I would rather something be in 2003."

Ryan says "2004 1 year I guess. For 1 year at HealthSouth. Then 2007."

They go on.

"I do not want to be lending to Source Medical Solution." And then somebody says "So you know." And then somebody says "Please, please explain. I am confused. I don't understand. You doubt the validity of the guarantee. Is there a problem with it?"

And Baudin says "I am not doubting the validity of the guarantee. I'm—what I do not like is the reputation that issues that (something inaudible) we are running with this entity. I do not like the fact that we keep getting asked to deal with these partially owned companies and a lot of it revolves around just the noise that is going on with the company. I mean, you know, the fact is there is an SEC investigation and the FBI is in there. It just smells bad" and then Chris Ryan says. "Okay. The—the—I think the firm—well, we ought to check if the firm wants to have a relationship with the company. But—and that's that. Then I think that is a fundamental issue. But at the firm let us just say we got a matter of resolving that which not—not me or this committee and I think it can. I agree with you. We should vet this before we lend anywhere money in, and that this transaction—make sure that this client that we want to continue to—to promote within the firm. But the firm decides to, whoever, I am not sure who that body is, but we will collect it. You know it is probably—maybe it is management committee, let us say at Warburg. Let us say they decided they want to push on the HealthSouth and therefore they want to try to accommodate the client where we can we like—do our other client."

And then Baudin says "Chris, we are being asking to accommodate of client in a fashion that we typically do not, have not. We do not get asked to accommodate other clients."

Chris Ryan "I disagree with that, David."

Baudin comes back “Asked to provide clients, we—we view as—as key clients of the firm and I am” Baudin says something. “But we should only be doing it for companies with decent reputations and this company’s tarnished its reputation in just about every which way over the last year.”

Ryan says “That is a fair—well, I think that is a fair comment, at least as near—as near as I can tell. And I do not think it is certainly—it is not my call to.”

And Baudin says “That clearing the way.”

Ryan says “Turn this on that basis? Yes. Shares are traded,” etcetera, etcetera.

Who is David Baudin?

Mr. MCGAHAN. I believe—I do not work at UBS anymore, but I believe he is the head of the credit area.

Mr. WALDEN. Mr. Lorello, is he head of the credit area?

Mr. LORELLO. Yes. Yes. He runs the—

Mr. WALDEN. Pardon me?

Mr. LORELLO. He runs the credit risk department.

Mr. WALDEN. He runs the credit risk department?

Mr. LORELLO. For the U.S.

Mr. WALDEN. For the United States at UBS? Are you familiar with him? Do you and he communicate?

Mr. LORELLO. No, we do not.

Mr. WALDEN. So you had no idea about the concern of the head of the credit department within UBS Warburg?

Mr. LORELLO. I became aware of this transcript in connection with recent preparation.

Mr. WALDEN. Okay. Then help me understand how this works in your company. You have these kind of people looking at these sorts of loans and all at the credit department. And what is your role? Your role, Mr. Lorello?

Mr. LORELLO. I run the healthcare group, investment banking group.

Mr. WALDEN. Okay. And so you have worked with Scrusy for a number of years?

Mr. LORELLO. Yes. Well, I have known him since 1987.

Mr. WALDEN. 1987. Okay. But HealthSouth, according to Mr. Scrusy’s emails has had a 20 years relationship with UBS?

Mr. LORELLO. It has actually been since 1999 at UBS when we joined. But with myself, it has been since 1987.

Mr. WALDEN. Since 1987? What as your relationship back in 1987? What were you doing?

Mr. LORELLO. I was at Salomon Smith Barney.

Mr. WALDEN. Okay. But you have been working with Mr. Scrusy and his company for some time helping them get financing, right?

Mr. LORELLO. That is correct.

Mr. WALDEN. So you would go out then and recommend to various individuals who might want to buy bonds, the credit worthiness of this company and that bond, or bonds, is that right? What do you do?

Mr. LORELLO. Well, can I—

Mr. WALDEN. Yes.

Mr. LORELLO. Perhaps put some of the pieces together here.

The interchange here is between the Chairman of the Commitment Committee, which is Chris Ryan, and one of the members of the Commitment Committee, which is David Baudin. He also was the chief credit person at UBS in the Americas.

The way the process works is that when a transaction mandate occurs, for instance, a loan, the deal team that is responsible for that client and responsible for that project puts a memorandum together, does the due diligence and then presents that to the Commitment Committee. The Commitment Committee is charged with approving or disapproving the loan. In this case, they actually turn the loan down. And they are an independent body within UBS that has the final authority over any transaction that the bankers are proposing. So that is the interplay here.

It is between two members of the Commitment Committee who are reviewing a loan for Source Medical. And who are making an assessment as to whether or not they want to proceed with that loan.

Mr. WALDEN. And they decide not to?

Mr. LORELLO. And they decide not to.

Mr. WALDEN. They raise some very disturbing questions, say, in back a year ago. I mean, there has been problems with transparency, there is problems with different board members on different committees and all.

Mr. MCGAHAN, were you familiar with any of this information or the concerns that were raised?

Mr. MCGAHAN. I was familiar at the time, yes. Mr. Leder and Mr. O'Neill had informed me that the credit committee was struggling with getting this loan approved. And the specific issues that they were struggling with was they wanted to get the audited financial information before they would approve the loan. And they also were struggling with the information flow. They did not think they were getting—

Mr. WALDEN. Well, they could not get a balance sheet, could they?

Mr. MCGAHAN. Over the short of time, that happened in February. In March, they could not get a balance sheet. They were trying to get financial information from HealthSouth and they would not approve the loan until they got that information.

I thought that this was an example of the process that was working. There was checks and balances in the system. The credit people were doing their jobs. And the bankers were proposing and advocating a loan for a client. And the process worked, which was that they did not approve the loan until they got an audited financial statement.

Mr. WALDEN. And you did not share any of this information with Mr. Lorello, was he aware of it at the time?

Mr. MCGAHAN. I was not aware of the specifics of Mr. Baudin's comments. I knew through Mr. O'Neill and Mr. Leder that the credit committee was struggling. And—but I thought we were in the middle of a credit process. I thought that what was happening was the credit folks were struggling to get to the goal line. I certainly forwarded on Mr. Scrushy's email to let Mr. Lorello know with my tag line that there was an issue. But I thought we were

in a process. And once the audited financial information came in, that perhaps we could get to the goal. But that never came in.

Mr. WALDEN. Okay. Mr. Lorello, did you follow up on that email that he sent you?

Mr. LORELLO. I do not specifically recall following up.

Mr. WALDEN. Did you follow up with Mr. Scrushy at all since he personally referenced you?

Mr. LORELLO. No. I did not speak to Mr. Scrushy or anyone else at HealthSouth.

Mr. WALDEN. Okay. What was your reaction? What did you do after you got—I mean, this is a pretty big client, is it not? Was this one of your bigger clients?

Mr. LORELLO. HealthSouth was an important client of our group. Earlier I think someone had asked, the accounts were about 2 percent of our revenues.

Mr. WALDEN. How about in your division, though?

Mr. LORELLO. In my group.

Mr. WALDEN. In your group, 2 percent of your revenues?

Mr. LORELLO. Yes. Yes.

Mr. WALDEN. Okay. All right.

Did you believe that HealthSouth's reputation was tarnished?

Mr. LORELLO. At this moment in time, March 2003?

Mr. WALDEN. Yes.

Mr. LORELLO. I looked at it as a company that was having some financial difficulties. And clearly a number of issues that were out there in the public market that were being vetted by our Commitment Committee and by others.

Being in the healthcare industry, it is not uncommon to have companies who are experiencing reimbursement issues. Many of our clients go through Medicare cuts. It is not unusual in healthcare generally because it is a volatile industry to see companies go into favor and out of favor.

So, these were clearly issues. But we were continuing to work with the company to try to help them.

Mr. WALDEN. Mr. McGahan, could we go to Tab 29? This was sent to Roderick O'Neill and Michael Leder.

Mr. MCGAHAN. Yes.

Mr. WALDEN. You can both read that and explain it to me?

Mr. MCGAHAN. Sure. Would you like me to read it out loud?

Mr. WALDEN. I am afraid so.

Mr. MCGAHAN. "I just got my ass wiped by Scrushy and Owens. The key is the amendment. So focus only on that for now. They need it by Tuesday. We must get it done. It must not leak into the market that we are struggling. If it does, we are all dead. Start with a detailed time line of how information has slowed over the past 2 weeks. We must all agree on specifics of this by tomorrow morning. We need the information from the company. Get Tadd and Richard Davis working on everything that you need. We must get this done. Our relationship is over."

Mr. WALDEN. What was your concern about something leaking into the market?

Mr. MCGAHAN. I am talking about the bank market. And first of all, I am reminding Mr. O'Neill and Mr. Leder about dealing with the confidential information of the client. And what we are working

with here is trying to get, I believe, a bank amendment approved. And our credit folks were struggling to get that done, as indicated by the—what we were just talking about.

I wanted to reenforce to Rod O'Neill and Mike Leder that they should tell the bank syndication folks to make sure that they treated the information confidentially until we either got the loan approved or we did not. And that is what I meant by that.

Mr. WALDEN. Okay. Back on the email from Christopher Ryan to you on March 7.

Mr. MCGAHAN. Which time again?

Mr. WALDEN. Well, you know, this is the whole back of the Scrusby email. Tab 34. And it really is the second page of Tab 34. And it is—I think you have written to Mr. Ryan saying “Chris, see the email string below from CEO. Obviously, he is pissed. I have Leder putting the time line together and I will send you any other information from the company. The CEO is solely focused on the amendment, not the 22 loan. What else can I do internally not to permanently blow up this relationship by not getting there as soon as possible on the amendment? Bill.”

Mr. MCGAHAN. Right.

Mr. WALDEN. And then his—could you read his response to you then?

Mr. MCGAHAN. Yes. He said—yes. “Internally not much. Externally it depends. If the time line exonerates HealthSouth, you know better than me. If the time line demonstrates duplicity, I would counsel Scrusby as a friend and an advisor to change the company’s attitude toward the debt markets. He will need them.”

Mr. WALDEN. Okay. What does he mean by if the time line demonstrates duplicity?

Mr. MCGAHAN. At this time, the credit folks and the credit process was being frustrated by their ability or lack of ability to get financial information from the company. They believed that they did not have a good understanding of what the year end earnings announcement was going to be. They thought it was going to be one thing, and I think it turned out to be another.

They also, I think there was a downgrade of the company’s earnings by a major rating agency, and they felt they did not know about that.

So there was not good information flow. They could not get at least a draft to the audited financial information. And so they felt that they were not being treated well.

And so what we are attempting to do here is get the information, get specific on what information we had, what we needed. And get specific on the time line of that information flow. And—but what Chris is saying to me in terms but if it turns out that they have not been treating the bank market, they have not been treating us well in terms of not giving us the information on time, not telling us about the rating agency downgrade, you should tell him he needs to change his attitude toward the debt market. And I agree with that.

Mr. WALDEN. Okay. So and the effect was UBS still pushing the billion dollar bond deal and a \$22 million loan at a time when this company basically is—

Mr. MCGAHAN. Well, the bond deal happened in May 2002. So that as done. So we are now in March 2003.

Mr. WALDEN. But was it not going to be registered in August?

Mr. MCGAHAN. It was in fact registered. Again, this is, unless I might have my dates confused, but this is Friday, March 7, 2003.

Mr. WALDEN. Right.

Mr. MCGAHAN. That happened—the bond deal happened, I believe, in May 2002 and was registered in August 2002. So—and I think I have that right.

Mr. WALDEN. Okay.

Mr. MCGAHAN. But what was happening here was this was 10 days before or so that the fraud was disclosed. We were not getting good information from HealthSouth. We're are struggling through a credit process, which I believe was working because we were waiting on audited financial information. So I think there was a process which was working, which was that there was an advocate for the corporate finance client, the credit folks which wanted the audited financial information. And it turned out that we were not going to do anything as an institution until we got that information.

Mr. GREENWOOD. The Chair thanks the gentleman.

One more quick series of questions for you, Mr. McGahan, and then we will wrap this up.

It was a billion dollar bond deal, a bond offering in May 2002. Are you familiar with that?

Mr. MCGAHAN. Yes, sir.

Mr. GREENWOOD. Okay. Now it is my understanding that HealthSouth initially filed with the SEC to register the bonds on June 28 and amended that filing on August 22. I have also been informed that in order for a registration to become effective, HealthSouth would have had to make some affirmative notification either by phone or writing within 48 hours of the effective date.

The question is what if between the time the bond offering was filed for registration and the time the SEC permits registration to take effect, for its registration to take effect, if HealthSouth were to learn about a material negative impact on its finances; what should happen to the pending bond registration?

Mr. MCGAHAN. My understanding, although I am not an attorney, my understanding is that it should be updated.

Mr. GREENWOOD. Updated or—

Mr. MCGAHAN. In terms of the disclosure. If they have learned new information, my understanding is—

Mr. GREENWOOD. So then they need to go, give that information to the—and put it into the SEC?

Mr. MCGAHAN. Into the SEC, that is my understanding. Although we were not advising HealthSouth on that. It is for their counsel and internal counsel.

Mr. GREENWOOD. So that is not UBS' responsibility?

Mr. MCGAHAN. Absolutely. We have nothing to do with that.

Mr. GREENWOOD. It is the company's responsibility?

Mr. MCGAHAN. Yes, sir.

Mr. GREENWOOD. And would the SEC likely postpone the permit?

Mr. MCGAHAN. I do not know.

Mr. GREENWOOD. The registration, I should say.

Mr. MCGAHAN. It is just an area that we work with them.

Mr. GREENWOOD. Now are you aware that yesterday's indictment of Mr. Scrushy includes "false statements, accounts directed to, among other things, the June and the August SEC registration filings for the bond issue?"

Mr. MCGAHAN. I was not aware of that. But that—

Mr. GREENWOOD. Okay. If you look at Tabs 20 and 21 in your book. They indicate that in August 2002 by looks at the Tab 20 email, at least as early as August 13, HealthSouth was preparing to issue a press regarding the impact of Transmittal 1753. The Tab 21 email and its attachment indicate that on August 23 the UBS team saw a copy of the press release that contained the disclosure of the Transmittal 1753 and its \$175 million impact on earnings. Is that what they indicate?

Mr. MCGAHAN. Yes, sir.

Mr. GREENWOOD. Okay. HealthSouth disclosed its financial hit to UBS on August 23 and issued the press release on August 27. And in between those dates on August 26 the registration became effective.

So I see it, UBS and HealthSouth had the opportunity to notify the SEC to postpone registration of the these bonds, is that not right?

Mr. MCGAHAN. No, sir. I was—we were—I personally was completely unaware of the registration process going on. And that is not anything that we have anything to do with at all. So—they work with outside counsel and attorneys on their public filings, but not with the investment bankers.

Mr. GREENWOOD. Did UBS inform their inside counsel that this was going on?

Mr. MCGAHAN. UBS did inform the—the proper folks in—in terms of inside counsel what we were working on, but we had no knowledge of the SEC filings or we were not reviewing them. Whatever HealthSouth was doing in terms of the bonding venture, we just did not have anything to do with.

Mr. GREENWOOD. On August 23 UBS knew that there was going to be \$175 million impact on the company, right?

Mr. MCGAHAN. Yes.

Mr. GREENWOOD. Both HealthSouth and UBS knew that?

Mr. MCGAHAN. I believe so, yes.

Mr. GREENWOOD. And you felt no obligation to disclose that information to the SEC?

Mr. MCGAHAN. Well, my understanding of this was that HealthSouth was in a mode to publicly disclose this as soon as they had their arms around it. They were telling all the people that they were working with, including their internal—all the lawyers they were working with, exactly what they were going to do.

But in terms of the public disclosures, we are not advising the company on what disclosures they make. But I was under the impression at the time that they were going down the road to a rapid disclosure of this information.

Mr. GREENWOOD. Well, why would they have sent those emails to you if you were not advising them on their disclosures?

Mr. MCGAHAN. What I was referring to was on their legal disclosures, their public filings with the SEC. This was a draft of a press

release that they sent around which they announced, I believe, within one or two business days of this circulation.

Mr. GREENWOOD. And UBS has no role whatsoever in the registration process for these bonds?

Mr. MCGAHAN. We do not.

Mr. GREENWOOD. And as far as you know, HealthSouth never informed the SEC on August 23 of this impact?

Mr. MCGAHAN. I just do not know. I have no idea.

Mr. GREENWOOD. Okay. Thank you.

And this time I mean. Thank you to all of you.

The hearing—without objection, we need to have all of the documents and the binders be entered into the record.

Without objection they will be entered.

And the hearing is adjourned.

[Whereupon, at 7:45 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

HealthSouth Document Binder 1  
Panels 1, 2, 3  
11/05/2003

Tab	Document Description	Date	Bate #
<b>Gregory Wallace Documents</b>			
1	Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines	10/7/2003	NA
<b>Joel Gordon Documents</b>			
2	SEC Proxy Stmt from 1998 Re: Shareholder Resolution	4/16/1999	NA
3	BOD Meeting Minutes & Draft Minutes	3/15/2002	679-0003
4	Corporate Compliance Cm'tee Minutes	3/16/2002	679-0016
5	Projected Effect of Outpatient Reimbursement Changes on Net Revenue	6/30/2002	02-00771
6	BOD Meeting Minutes & Draft Minutes	8/8/2002	456
7	BOD Meeting Minutes & Draft Minutes	8/26/2002	18-02291
8	Gordon Ltr to Scrusby Re: Project Crimson	8/30/2002	JG 1018
9	BOD Meeting Minutes & Draft Minutes	9/17/2002	18-02297
10	BOD Meeting Minutes & Draft Minutes	10/1/2002	18-02306
11	Gordon memo to Horton Re: Board meeting concerns	10/8/2002	355-0062
12	Gordon letter to Watkins Re: Recent Board meeting events/concerns	10/8/2002	61
13	Davis Ltr to Gordon Re: Your letter of Oct. 8, 2002 to Richard Scrusby	10/15/2002	408-1411
14	BOD Meeting Minutes & Draft Minutes	10/29/2002	JG 479
15	Gordon Letter to Davis Re: Responding to Oct. 15, 2002 letter	11/1/2002	355-0100
16	Dennis Danko Letter to Gordon Re: Expressing Shareholder Concerns	11/8/2002	JG 546
17	Gordon Memo To Brad Hale Re: Board Minutes	3/12/2003	JG 688
18	Bill Owens email to G. Strong Re: Thursday Mtg	2/24/2003	676-0051
19	HealthSouth 8 Year Operating History (Gordon handwritten notes)	NA	JG 1038
<b>Robert May Documents</b>			
20	BOD Meeting Minutes & Draft Minutes	10/15/2002	18-02310
21	BOD Meeting Minutes- Handwritten	10/29/2002	293-0253
22	Davis email to Eric Hanson Re: Draft press releases -- alternative versions	10/30/2002	1863
23	Smith email to Davis Re: FTI remaining fees owed \$116,756	11/12/2002	2379
24	May memo to Hale & Horton Re: Minutes	3/12/2003	JC 1227
25	May memo to George Strong Re: 10 K Signature(s) 2003	6/11/2003	RM 388
26	May facsimile to Jon Hanson Re: BOD Recommendations	8/18/2003	NA
<b>Sage Givens Documents</b>			
27	BOD Meeting Minutes	8/5-7/1994	427-0308
28	SEC Proxy Disclosure Form	4/17/1998	NA
29	BOD Meeting Minutes	8/10/2000	18-02152
30	HealthSouth Audit Committee Charter	8/10/2000	18-02161
31	2001 Proxy Stmt stating the Audit Cm'tee met only 1 time in 2001	4/12/2002	NA
32	Handwritten BOD Meeting Minutes	8/8/2002	388-0441
33	BOD Meeting Minutes	8/26/2002	18-02291
34	BOD Meeting Minutes - Handwritten	8/26/2002	293-0465
35	Horton email to Brad Hale & Weston Smith Re: Audit Committee	9/29/2002	583-00192

HealthSouth Document Binder 1  
Panels 1, 2, 3  
11/05/2003

36	Smith email to Emery Harris Re: Audit Committee	10/7/2002	583-00489
37	Horton email to Gail Watson Re: Clarification on Audit Cm'tee Charter	10/21/2002	583-00987
38	BOD Meeting Minutes (F&J)	10/22/2002	18-02313
39	BOD Meeting Minutes (Patton Boggs)	10/22/2002	247-1855
40	FTI memo from Cohen to Owens Re: F&J Report- Open Items and Follow-up Questions From Earnings Announcement	11/6/2002	44-1119
41	BOD Meeting Minutes	11/13/2002	18-01801
42	Hale memo to Givens Re: Board Minutes	2/28/2003	1182
<b>Larry Striplin Documents</b>			
43	Compensation Committee Meeting Minutes	1/25/2001	18-01806
44	Brasfield & Gorrie Subcontract Agreement	9/11/2001	412-0020
45	U/C in Lieu of Meeting of BOD (Mattola shares)	2/4/2002	PW 103
46	Medistar memo to Monzer Hourani Re: Glass	2/6/2002	412-0078
47	Medistar memo to Monzer Hourani Re: Nelson Brantley Glass Contractors	4/12/2002	412-0079
48	Corporate Compensation Committee Meeting Minutes	4/29/2002	18-01837
49	Brasfield & Gorrie Re: Glass Pricing	5/8/2002	412-0139
50	Corporate Compensation Committee Meeting Minutes	7/25/2002	18-01841
51	Esclavon email to Scrusy Re: Striplin and Stark are here & ready to look at glass whenever you come in.	7/29/2002	134-0511
52	Corporate Compensation Committee Meeting Minutes	7/31/2002	18-01839
53	Corporate Compensation Committee Meeting Minutes	9/2/2002	18-01840
54	Mercer Report Re: Officer Compensation & Stock Grant Summaries	2/26/2003	LS 445
<b>Philip Watkins Documents</b>			
55	Tanner, Watkins Ltr to Scrusy Re: changing the mix of the Board	9/30/1999	688-0038
56	Scrusy Appt Re: Meeting with Dr. Watkins	8/20/2002	141-0898
57	Watkins email to Horton Re: Various Documents Attached	1/17/2002	355-0096
58	Watkins email to Givens et al Re: Delaware SLC case	1/18/2003	674-0047
59	Scrusy email to Watkins Re: Telling Watkins to resign	2/5/2003	674-0009
60	Horton email to Hale Re: Compensation Committee's approval for Scrusy loan repayment.	3/10/2003	583-02137
<b>Board of Directors Documents</b>			
61	Pulling the Wagon-- Integrity in Action' Corporate Compliance Orientation	NA	259-0247
62	Capitalization Table MedCenterDirect.Com	5/16/2002	5181
63	HS doc Re: Clinical Considerations & Implications of Group Therapy Coding in the Medicare Population	7/26/2002	414-0177
64	Huffman email Re: RMS Conf. Call	7/29/2002	559-0245
65	Taylor email to Szush Re: Owens memo on Group Therapy	8/1/2002	301-1247
66	F&J memo to May Re: Notice Regarding Document Review (shreds)	10/31/2002	3421
67	Court of Chancery of the State of Delaware	1/16/2003	NA
68	Wyler email to Bawden Re: Summary of Transactions, guaranteed by HS	2/27/2003	163309
<b>Richard Dandurand Documents</b>			
69	Ernst & Young Report Re: HealthSouth	4/3/1995	35926



Richard Bednar  
Mary Beth Buchanan  
Paul Fiorelli  
Richard Gruner  
Eric H. Holder, Jr.  
Charles Howard  
Ron James  
B. Todd Jones, Chair

Lisa A. Kuca  
Jane Adams Nangle  
Edward S. Petry  
Julie O'Sullivan, Reporter  
Winthrop M. Swenson  
Gregory J. Wallace  
Gary R. Spratling

Tab 1

**REPORT OF THE  
AD HOC ADVISORY GROUP ON  
THE ORGANIZATIONAL  
SENTENCING GUIDELINES**

**OCTOBER 7, 2003**

## II. EXECUTIVE SUMMARY

### A. OVERVIEW

The Advisory Group's review of the operation and impact of the organizational sentencing guidelines, detailed in Part III of this Report, compelled the conclusion that the organizational sentencing guidelines have been successful in inducing many organizations, both directly and indirectly, to focus on compliance and to create programs to prevent and detect violations of law. The Advisory Group also concluded, however, that changes can and should be made to give organizations greater guidance regarding the factors that are likely to result in *effective* programs to prevent and detect violations of law. Two circumstances were particularly influential in shaping the Advisory Group's efforts in this respect.

First, the Advisory Group concluded that recent revelations of widespread misconduct in some of the nation's largest publicly held companies – misconduct perpetrated at the highest levels of corporate leadership that went undetected despite the existence of compliance programs – required evaluation of whether the compliance efforts precipitated by the organizational sentencing guidelines could be made more effective in preventing and detecting violations of law. The Advisory Group drew a variety of lessons from the legislative and regulatory responses to the organizational misconduct revealed over the last several years. For example, the Advisory Group concluded that the guidelines should better address the role of organizational leadership in ensuring that compliance programs are valued, supported, periodically re-evaluated, and operate for their intended purpose. Further, the recent emphasis by Congress and regulators on a number of additional factors, including organizational culture, improved internal reporting systems, adequate training, auditing and monitoring, and periodic risk assessments, also influenced the Advisory Group's analysis and final recommendations.

Second, much has changed in the field of organizational compliance since the advent of the organizational sentencing guidelines in November 1991. Over the last twelve years legal standards in a remarkably diverse range of fields have recognized organizational law compliance programs as important features of responsible organizational conduct. The legal standards which have emerged are often built upon the original organizational sentencing guidelines model. However, these standards have increasingly articulated more detailed and sophisticated criteria for identifying organizational law compliance programs that warrant favorable organizational treatment. Efforts and experience by industry and private organizations have also contributed to an evolution of "best practices" during the last decade. In short, the Advisory Group believes that the organizational guidelines should be updated to reflect the learning and progress in the compliance field since 1991.

### B. SEPARATE GUIDELINE FOR EFFECTIVE PROGRAMS

The Advisory Group proposes that the Sentencing Commission consider several specific revisions to the current organizational sentencing guidelines to reflect these developments. The Advisory Group recommends that the Sentencing Commission promulgate a stand-alone guideline at §8B2.1 defining an “effective program to prevent and detect violations of law.” (*See* Appendix B). Many of the concepts detailed in the proposed guideline provision are well recognized and are currently reflected in Application Note 3(k) to §8A1.2.

Within the proposed new guideline that is accompanied by a section-by-section analysis in Part IV, the Advisory Group recommends that the Sentencing Commission make the following modifications and additions:

- Emphasize the importance within the guidelines of an organizational culture that encourages a commitment to compliance with the law
- Provide a definition of “compliance standards and procedures”
- Specify the responsibilities of an organization’s governing authority and organizational leadership for compliance
- Emphasize the importance of adequate resources and authority for individuals within organizations with the responsibility for the implementation of the effective program
- Replace the current terminology of “propensity to engage in violations of law” with language that defines the nature of an organization’s efforts to determine when an individual has a reason to know, or history of engaging in, violations of law
- Include training and the dissemination of training materials and information within the definition of an “effective program”
- Add “periodic evaluation of the effectiveness of a program” to the requirement for monitoring and auditing systems
- Require a mechanism for anonymous reporting
- Include the phrase “seek guidance about potential or actual violations of law” within the criteria in order to more specifically encourage prevention and deterrence of violations of law as part of compliance programs

- Provide for the conduct of ongoing risk assessments as part of the implementation of an “effective program”

These proposed changes are intended to eliminate ambiguities revealed by twelve years of sentencing experience and to describe more fully those essential attributes of successful compliance programs revealed by many years of program development and testing. They are also designed to respond to the lessons learned through the experience of national corporate scandals over the last two years and to synchronize the organizational sentencing guidelines with new federal legislation and emerging public and private regulatory requirements.

### C. ROLE OF WAIVER IN COOPERATION

The Advisory Group also evaluated whether the current organizational sentencing guidelines adequately define self-reporting and cooperation, and whether the guidelines sufficiently encourage organizations to self-report their own illegal conduct and cooperate with federal law enforcement. The Advisory Group also examined whether the guidelines should provide commentary on role of the waiver of the attorney-client privilege and the work product protection doctrine in receiving credit for cooperation under the guidelines. These issues, particularly the question of whether the guidelines should be amended to provide some commentary on the role of waivers, are of great interest and concern to both the U.S. Department of Justice and to members of the defense bar.

As described at length in Part V of this Report, there is a significant divergence of opinion and perceptions among practitioners within the defense bar and the U.S. Department of Justice as to this important issue. Several of the critical issues examined by the Advisory Group include: (1) the appropriate use of, or need for, waivers of privilege as a part of the cooperation process; (2) the level of communication and understanding of the U.S. Department of Justice policies and practices, and whether there is consistency within various U.S. Attorney’s Offices; and, (3) the value of suggesting that the organizational sentencing guidelines address the role of waivers in obtaining credit for cooperation. Following significant analysis and discussion, including a field survey of a number of United States Attorney’s Offices, the Advisory Group has identified a possible approach to modifying the organizational sentencing guidelines in this regard.

Accordingly, the Advisory Group recommends adding clarifying language regarding the role of waiver of such privileges and protections for purposes of receiving sentencing credit based on cooperation with the government during the investigation and prosecution of an organization. In particular, it suggests amending the Commentary to §8C2.5 and adding Commentary to §8C4.1 as follows:

- Amend the Commentary at Application Note 12 of existing Section 8C2.5 by adding the following sentence:

**If the defendant has satisfied the requirements for cooperation set forth in this note, waiver of the attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subsection(g). However, in some circumstances waiver of the attorney-client privilege and of work product protections may be required in order to satisfy the requirements of cooperation.**

- Amend the Commentary at existing Section 8C4.1 by adding an Application Note 2 as follows:

**Waiver of Certain Privileges and Protections. – If the defendant has satisfied the requirements for substantial assistance set forth in subsection(b)(2), waiver of the attorney-client privilege and of work product protections is not a prerequisite to a motion for a downward departure by the government under this section. However, in some circumstances, the government may determine that waiver of the attorney-client privilege and of work product protections is necessary to ensure substantial assistance sufficient to warrant a motion for departure.**

#### **D. THE LITIGATION DILEMMA**

The Advisory Group also studied whether the effectiveness of compliance programs could be enhanced, not only by focusing on internal organizational efforts, but also by addressing the exogenous pressures that temper the clear benefits of proactive structures. There is substantial evidence demonstrating that, as strong as the guidelines' compliance incentives are, equally weighty incentives created by forces *outside* the organization may persuade organizations to pursue less than optimal, and in some cases, ineffective compliance programs.

Specifically, as is explored at length in Part VI of this Report, the institution of truly effective programs, the auditing and monitoring that such programs require, and the training and internal reporting systems that such programs contemplate, all create a real risk that information generated by these admirable practices will be used by other potential litigants to harm the organization. This situation is often referred to as the "litigation dilemma," and it is recognized as one of the major greatest impediments to the institution or maintenance of truly effective compliance programs.

The litigation dilemma, and the related issue of waivers of attorney-client privilege and the work product protection doctrine, also have a potential negative impact on organizational incentives to self-report misconduct and cooperate in the investigation and rededication of that wrongdoing. Recognizing that the litigation dilemma cannot be resolved within the organizational sentencing guidelines themselves, the Advisory Group is compelled by practicality to signal the pivotal role that the organizational sentencing guidelines play in this dilemma. Consequently, the Advisory Group recommends that the Sentencing Commission initiate and foster further dialogue toward a resolution of the “litigation dilemma” with appropriate policy makers, including Congress, based on the preliminary observations outlined by the Advisory Group in Part VI.

#### **E. FAILURE TO IMPLEMENT A COMPLIANCE PROGRAM**

The Advisory Group considered the recommendation received in the public comment for an increase in the culpability score of sentenced organizations for the absence of an “effective program.” The Advisory Group recommends against such an increase because of the disparate impact that such an increase may have on small organizations, as is discussed more extensively at Part VII.

#### **F. OTHER ASPECTS OF ORGANIZATIONAL SENTENCING**

Finally, in the course of its work, the Advisory Group identified a number of areas relating to the sentencing of organizations that are beyond the scope of its mandate and term, but that are in strong need of further study and evaluation. Accordingly, as set forth more fully in Part VII, the Advisory Group recommends that the Sentencing Commission:

- Study the supervision of organizations on probation, particularly with respect to implementing compliance programs, and consider whether the statutory maximum of five years is too limiting for this and other purposes of probation
- Study the relationship of the fine table to the statutory maximum fine
- Evaluate the revised definitions of “loss” at §2B1.1 in the context of Chapter Eight and the impact upon organizational defendants
- Focus on training and outreach to small business organizations

The members of the Advisory Group wish to thank the Sentencing Commission for this opportunity to serve the public through its service these past eighteen months, and individual members stand ready to assist the Commission and other policy makers if called upon for further assistance.

April 16 1999

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 CONFORMED PERIOD OF REPORT: 19990520  
 FILED AS OF DATE: 19990416

Tab 2

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 CENTRAL INDEX KEY: 0000785161  
 STANDARD INDUSTRIAL CLASSIFICATION: 8093  
 IRS NUMBER: 630860407  
 STATE OF INCORPORATION: DE  
 FISCAL YEAR END: 1231

FILING VALUES:  
 FORM TYPE: DEF 14A  
 SEC ACT:  
 SEC FILE NUMBER: 001-10315  
 FILM NUMBER: 99595470

BUSINESS ADDRESS:  
 STREET 1: ONE HEALTHSOUTH PKWY  
 STREET 2: STE 224W  
 CITY: BIRMINGHAM  
 STATE: AL  
 ZIP: 35243  
 BUSINESS PHONE: 2059677116

MAIL ADDRESS:  
 STREET 1: ONE HEALTHSOUTH PARKWAY  
 CITY: BIRMINGHAM  
 STATE: AL  
 ZIP: 35243

FORMER COMPANY:  
 FORMER CONFORMED NAME: HEALTHSOUTH REHABILITATION CORP  
 DATE OF NAME CHANGE: 19920703

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5/19/2003

## THE LONGVIEW PROPOSAL

Amalgamated Bank of New York LongView Collective Investment Fund, 11-15 Union Square, New York, New York 10003, claiming beneficial ownership of 55,100 shares of the Company's Common Stock, has submitted the proposal set forth below (the "LongView Proposal", as defined above):

## "SHAREHOLDER RESOLUTION

"RESOLVED that the shareholders request the Board of Directors to amend the articles of incorporation and/or bylaws to the extent necessary to provide that at least three-quarters of all Board members are independent. For purposes of this resolution, an independent director shall be considered as one who:

- o has not been employed by HEALTHSOUTH or an affiliate in an executive capacity;

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- o has not been a member of a corporation or firm that is one of HEALTHSOUTH's paid advisers or consultants;
- o has not been employed by a significant customer of or supplier to HEALTHSOUTH;
- o has not had personal services contracts with HEALTHSOUTH or one of its affiliates;
- o has not been employed by a foundation or university that receives significant grants or endowments from HEALTHSOUTH;
- o is not a relative of an executive of HEALTHSOUTH or one of its affiliates;
- o has not been part of an interlocking directorate in which the CEO or other executive officer of HEALTHSOUTH serves on the board of another corporation that employs that director; and
- o does not have any personal, financial and/or professional relationships with the CEO or other executive officer that could interfere with the exercise of independent judgment by such director.

## "SUPPORTING STATEMENT

"This proposal seeks to establish a level of independence that we believe will permit clear and objective decision-making in the best long-term interest of all shareholders.

"Five of HEALTHSOUTH's 12 Directors are company insiders. A sixth is the CEO of MedPartners, and HEALTHSOUTH's CEO, Richard M. Scrusby, is former Chairman and current director of MedPartners' Board of Directors. As a result, HEALTHSOUTH falls short of the level of independence proposed in this resolution.

"In our view, Board dominance by insiders and people having other significant ties to management can raise questions about whether a Board is giving priority to management's interest at the expense of the shareholders. As a committee of the Business Roundtable put it:

'Boards of Directors at large publicly-held corporations should be composed predominately of independent directors who do not hold management responsibilities within the corporation. . . . In order to underscore their independence, non-management directors should not be dependent on the companies on whose boards they serve.'

"We believe that greater board independence is particularly important at this time. After years of growth, HEALTHSOUTH's stock price has plummeted since late 1997. The company's performance for the past five years now lags behind that of the S&P 500 index.

"We also believe that greater independence is needed in light of HEALTHSOUTH's record on executive compensation. Our CEO was recently named as one of ten 'executive pay anti-heroes' by Graef Crystal, an expert on executive pay, in a report prepared for the Council of Institutional Investors. Crystal's conclusion was based in part on Mr. Scrushy's drawing a base salary 350% above the market; a salary and bonus 592% above the market; and a total direct compensation that is 225% above the market.

"We urge you to vote FOR this resolution."

#### RESPONSE OF THE BOARD OF DIRECTORS

The Board of Directors recommends a vote AGAINST the LongView Proposal, for the reasons set forth below.

The Company's Board of Directors agrees that the management of the Company should be vested in a Board of Directors consisting of a majority of independent directors. For that reason, the Company has always maintained just such a majority on its Board. The Board of Directors currently consists of seven outside Directors and five inside Directors. The outside directors comprise two of the nation's leading healthcare venture capitalists, the former chief financial officer of a large hospital chain, a veteran of senior executive positions with large retail and manufacturing enterprises, one of Alabama's most

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successful entrepreneurs, a leading physician and a healthcare executive identified by HealthcareBusiness magazine as having been involved in the start-up of over 15 healthcare companies. The Company's current inside Directors comprise two founders of the Company, as well as its Chief Operating Officer, its Chief Financial Officer and the Chief Operating Officer of its largest division. Only one member of the Company's Board of Directors is paid for consulting services, and that member, Joel C. Gordon, founded Surgical Care Affiliates, a pioneering company in the outpatient surgery business that was acquired by the Company in 1996. The Board of Directors believes that its current composition affords it a combination of independence, experience and knowledge of the healthcare industry and the Company's business that has served the Company and its stockholders well.

Each outside director meets the definition of independence adopted by the New York Stock Exchange, which excludes any director who has "any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment". Further, each outside director other than Mr. Gordon meets the more stringent test of being an "outside director" under the regulations promulgated under Section 162(m) of the Internal Revenue Code of 1986, as amended (which regulations provide, among other things, that an outside

director cannot be a current ~~employee~~, a former employee receiving compensation for prior services (subject to ~~certain~~ exceptions), a current or former officer of the corporation, or a ~~person~~ who receives (or is entitled to receive) remuneration from the corporation in any capacity other than as a director).

The Board of Directors ~~believes~~ that the requirements proposed under the LongView Proposal are arbitrary, unnecessary and inappropriate in that, unlike the standards imposed by the New York Stock Exchange and the Internal Revenue Code, such requirements would, for example, presume that a director was not independent because that ~~director~~ was an employee of a company that engaged in arm's-length commercial transactions with the Company in the ordinary course of business, or of a foundation ~~or university~~ that received grants or endowments from the Company. The Company ~~operates~~ in all 50 states, the United Kingdom and Australia, and as a consequence ~~has~~ customer or supplier relationships with a wide range of other companies around the world which may or may not meet the undefined and subjective standard of being "significant". Likewise, as part of its policy of corporate ~~stewardship~~, the Company provides support to a number of charitable foundations and ~~educational~~ institutions around the country. The arbitrary requirements contained in the LongView Proposal would, without further inquiry into the substantive ~~independence~~ of the directors, automatically bar any employees of such companies, foundations and institutions from being considered as independent ~~directors~~, potentially depriving the Committee of knowledgeable and experience ~~insight~~ into the matters facing it. Thus, for example, current or former ~~executives~~ of such companies as General Electric, Delta Airlines and Wal-Mart, and current and former administrators of such institutions as Vanderbilt ~~University~~, the University of Virginia or the Arthritis Foundation, would ~~not~~ be regarded as "independent" directors under the LongView proposal.

In support of its proposal, LongView attributes an industry-wide decline in stock prices to the performance of the Company's board notwithstanding the Company's continuing record of ~~earnings~~ growth, and makes a gratuitous attack upon the Company's Chairman ~~of the Board~~ and Chief Executive Officer, who has voluntarily forgone his own ~~salary~~ during the decline in the Company's stock price. In addition, the LongView supporting statement indicates that MedPartners' Chief Executive ~~Officer~~ serves on the Company's Board, which is no longer correct. LongView ~~offers~~ these dubious rationales in the face of the performance that the Company ~~has~~ seen under its existing Board structure, under which the Company:

- \* has become the only ~~healthcare~~ services provider to operate facilities in all 50 states
- \* has met or exceeded ~~analysts'~~ expectations for 50 consecutive quarters;
- \* has become part of the S&P 500 only 13 years after inception; and
- \* has become one of the ~~top~~ publicly traded healthcare services companies to maintain investment grade ratings with Standard & Poor's and Moody's;

all while becoming the nation's largest provider of outpatient surgery and rehabilitative healthcare ~~services~~. The Board believes that its existing policies with respect to membership have served the Company and its stockholders well, and that the LongView Proposal is unnecessary and inadvisable.

## VOTE REQUIRED; RECOMMENDATION OF THE BOARD OF DIRECTORS

The Board of Directors recommends a vote AGAINST the LongView Proposal. The affirmative vote of the holders of a majority of the outstanding shares of the Common Stock present or represented and entitled to vote at the Annual Meeting will be necessary for stockholder approval of the LongView Proposal.

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## EXECUTIVE COMPENSATION AND OTHER INFORMATION

## EXECUTIVE COMPENSATION -- GENERAL

The following table sets forth compensation paid or awarded to the Chief Executive Officer and each of the other four most highly compensated executive officers of the Company (the "Named Executive Officers") for all services rendered to the Company and its subsidiaries in 1996, 1997 and 1998.

## SUMMARY COMPENSATION TABLE

<TABLE>  
<CAPTION>

NAME AND PRINCIPAL POSITION	YEAR	ANNUAL COMPENSATION		LONG-T
		SALARY	BONUS/ANNUAL INCENTIVE AWARD	STOCK OPTI AWARD
<S>	<C>	<C>	<C>	<C>
Richard M. Scrushy	1996	\$3,391,775	\$ 8,000,000	1,500,
Chairman of the Board	1997	3,398,999	10,000,000	1,300,
and Chief Executive Officer(3)	1998	2,777,829	--	1,500,
James P. Bennett	1996	496,590	800,000	200,
President and Chief	1997	639,161	1,500,000	700,
Operating Officer	1998	670,000	--	300,
Michael D. Martin	1996	281,644	750,000	120,
Executive Vice President	1997	359,672	2,000,000	450,
and Chief Financial Officer	1998	415,826	--	260,
P. Daryl Brown	1996	335,825	400,000	100,
President -- HEALTHSOUTH	1997	370,673	450,000	250,
Outpatient Centers	1998	386,212	--	75,
Anthony J. Tanner	1996	298,078	350,000	100,
Executive Vice President --	1997	371,114	450,000	450,
Administration and Secretary	1998	388,422	--	250,

&lt;/TABLE&gt;

(1) Includes car allowances of \$500 per month for Mr. Scrushy and \$350 per month for the other Named Executive Officers in 1996 and 1997, use of a Company-owned automobile by Mr. Scrushy in 1998, and car allowances of \$500 per month for Mr. Scrushy and \$450 per month for the other Named Executive Officers through September 1998. Also includes (a) matching contributions under the Company's Retirement Investment Plan for 1996, 1997 and 1998, respectively, of: \$708, \$731 and \$1,450 to Mr. Scrushy; \$1,425, \$1,425 and \$1,499 to Mr. Bennett; \$1,331, \$1,324 and \$1,395 to Mr. Martin; \$1,897, \$1,319 and \$1,415 to Mr. Brown; and \$1,290, \$1,215 and \$1,308 to Mr. Tanner; (b) awards under the Company's Employee Stock Benefit Plan for 1996, 1997 and 1998, respectively, of \$3,389, \$2,889 and \$2,882 to Mr. Scrushy; \$3,387,

HEALTHSOUTH Corporation  
MEETING OF THE CORPORATE COMPLIANCE COMMITTEE  
OF THE BOARD OF DIRECTORS

MARCH 15, 2002

MINUTES

Tab 3

A Meeting of the Corporate Compliance Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held at the Disney Coronado Springs Resort in Orlando, Florida on March 15, 2002.

The following members were present: Joel C. Gordon, Phillip C. Watkins, M.D., Charles W. Newhall III and Brandon O. Hale, Senior Vice President - Administration and Corporate Compliance Officer of the Corporation. The following guests were also present: Richard M. Scrushy, Chairman of the Board and Chief Executive Officer of the Corporation, William T. Owens, President and Chief Operating Officer and Director of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, and Thomas C. Fox with the law firm of Reed Smith LLP. With the exception of Mr. Fox, who participated in the Meeting via a telephonic connection, all members and guests were physically present.

Mr. Gordon acted as Chairman and Mr. Hale acted as Secretary of the Meeting. The Meeting was called to order by Mr. Gordon at 8:32 a.m. E.S.T.

Mr. Gordon opened the Meeting, and Mr. Horton introduced Mr. Fox to the group and asked him to give the Committee an update on the *U.S. ex rel. Manning v. HEALTHSOUTH* whistleblower case. Mr. Fox provided the Committee with a summary of the facts and an overview of the procedural issues involved in the case. Mr. Fox advised the Committee that after two and one-half years of study and research on the case, he feels that there is no basis for the claim being made against HEALTHSOUTH. Additionally, Mr. Fox felt that the Corporation's position is very strong and stated that the HEALTHSOUTH model for physical therapy is the business model of the

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industry on physical therapy. The Committee was given an opportunity to question Mr. Fox regarding all issues in the case.

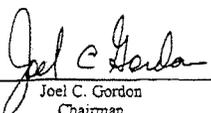
**Compliance Report**

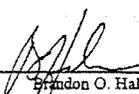
Mr. Hale presented to the Committee an update on Compliance Program activities. He reviewed a summary of the Compliance Hotline and Compliance Department initiatives for the first quarter 2002, outlined the schedule for the 2002 HCAR Program and provided results of the HCAR audits for 2001. Mr. Hale also updated the Committee on the audit requirements of the Corporate Integrity Agreement which are being conducted by KPMG.

**Other Business**

Mr. Hale proposed one change to Policy #302 in the Corporate Compliance Policy and Procedure manual, changing the requirement for refresher training from a two-year required refresher training to an annual required refresher training (copy attached). Mr. Hale also proposed the addition of Policy #203 Sanction Policy (copy attached). Both the change to Policy #302 and the addition of Policy #203 of the Corporate Compliance Policy and Procedure manual were unanimously approved by the Committee.

There being no further business to transact, the Meeting was adjourned.

  
\_\_\_\_\_  
Joel C. Gordon  
Chairman

  
\_\_\_\_\_  
Brandon O. Hale  
Secretary





Projected Effect of Outpatient Reimbursement Changes on Net Revenue

	Proforma 1	Proforma 2	Proforma 3	Proforma 4	Proforma 5	Proforma 6	Average	Percentage to Total
Hospital Outpatient Medicare	54,128,504	48,355,204	54,128,504	56,511,136	47,347,168	47,713,727	51,364,041	31%
Hospital Outpatient Non Medicare	51,052,971	51,052,971	41,961,591	81,370,980	51,052,971	51,052,971	54,590,742	32%
<b>Totals</b>	<b>105,181,475</b>	<b>99,408,175</b>	<b>96,090,095</b>	<b>137,882,116</b>	<b>98,400,139</b>	<b>98,766,697</b>	<b>105,954,783</b>	<b>63%</b>
Freestanding Outpatient Centers Medicare	16,239,303	20,878,104	25,132,255	11,589,502	28,805,431	9,279,602	18,658,866	11%
Freestanding Outpatient Centers Non Medicare	43,229,570	43,229,570	43,229,570	43,229,570	43,229,570	43,229,570	43,229,570	26%
<b>Totals</b>	<b>59,468,873</b>	<b>64,107,674</b>	<b>68,361,825</b>	<b>54,819,072</b>	<b>72,035,000</b>	<b>52,509,171</b>	<b>61,888,436</b>	<b>37%</b>
<b>Grand Totals</b>	<b>164,650,348</b>	<b>163,515,849</b>	<b>164,451,920</b>	<b>192,711,187</b>	<b>170,435,139</b>	<b>151,275,869</b>	<b>167,843,219</b>	<b>100%</b>

Tab 5

**Projected Effect of Outpatient Reimbursement Changes on Net Revenue  
Hospital Outpatient  
Proforma 1**

		YTD 6/30/02 Visits	Avg. Billable Units	Total Units	Net Revenue Per Unit	Net Revenue	Annualized Net Revenue
<b>Current Pricing and Volumes</b>							
M/C One to One	20%	76,366	4.0	305,466	\$ 26.00	7,942,106	15,884,211
M/C Concurrent	80%	305,466	4.0	1,221,862	\$ 26.00	31,758,422	63,516,845
Non M/C		<u>893,941</u>	4.0	<u>3,575,764</u>	\$ 33.25	<u>118,894,153</u>	<u>237,788,306</u>
		1,275,773		5,103,092		158,604,681	317,205,362
<b>Projected Pricing and Volumes</b>							
M/C One to One	20%	76,366	3.60	274,919	\$ 26.00	7,147,895	14,295,790
M/C Concurrent	80%	305,466	1.00	305,466	\$ 18.00	5,498,381	10,996,762
Non M/C One to One	85%	759,850	3.60	2,735,459	\$ 33.25	90,954,027	181,908,054
Non M/C Concurrent	15%	<u>134,091</u>	1.00	<u>134,091</u>	\$ 18.00	<u>2,413,641</u>	<u>4,827,281</u>
		1,275,773		3,449,935		106,013,944	212,027,887
<b>Hospital Outpatient- Decrease in Medicare Net Revenue</b>							<b>54,128,504</b>
<b>Hospital Outpatient- Decrease in Non-Medicare Net Revenue</b>							<b>51,052,371</b>
<b>Hospital Outpatient- Decrease in Total Net Revenue</b>							<b><u>105,181,475</u></b>

**HHEC 02-00772**  
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**Projected Effect of Outpatient Reimbursement Changes on Net Revenue**  
**Hospital Outpatient**  
**Proforma 2**

		YTD 6/30/02 Visits	Avg. Billable Units	Total Units	Net Revenue Per Unit	Net Revenue	Annualized Net Revenue
<b>Current Pricing and Volumes</b>							
M/C One to One	30%	114,550	4.0	458,198	\$ 26.00	11,913,158	23,826,317
M/C Concurrent	70%	267,282	4.0	1,069,130	\$ 26.00	27,797,370	55,594,739
Non M/C		<u>893,941</u>	4.0	<u>3,575,764</u>	\$ 33.25	<u>118,894,153</u>	<u>237,798,306</u>
		1,275,773		5,103,092		158,604,681	317,209,362
<b>Projected Pricing and Volumes</b>							
M/C One to One	30%	114,550	3.60	412,379	\$ 26.00	10,721,843	21,443,685
M/C Concurrent	70%	267,282	1.00	267,282	\$ 18.00	4,811,083	9,622,166
Non M/C One to One	85%	759,850	3.60	2,735,459	\$ 33.25	90,954,027	181,908,054
Non M/C Concurrent	15%	<u>134,091</u>	1.00	<u>134,091</u>	\$ 18.00	<u>2,413,641</u>	<u>4,827,281</u>
		1,275,773		3,549,212		108,900,594	217,801,187
<b>Hospital Outpatient- Decrease in Medicare Net Revenue</b>						<b>48,355,204</b>	
<b>Hospital Outpatient- Decrease in Non-Medicare Net Revenue</b>						<b>51,052,971</b>	
<b>Hospital Outpatient- Decrease in Total Net Revenue</b>						<b>99,408,175</b>	

**HHEC 02-00773**  
**Confidential Treatment**  
**Requested by HealthSouth Corp**

**Projected Effect of Outpatient Reimbursement Changes on Net Revenue  
Hospital Outpatient  
Proforma 3**

		<u>YTD</u> <u>6/30/02</u> <u>Visits</u>	<u>Avg.</u> <u>Billable</u> <u>Units</u>	<u>Total</u> <u>Units</u>	<u>Net</u> <u>Revenue</u> <u>Per Unit</u>	<u>Net</u> <u>Revenue</u>	<u>Annualized</u> <u>Net</u> <u>Revenue</u>
<b>Current Pricing and Volumes</b>							
M/C One to One	20%	76,366	4.0	305,466	\$ 26.00	7,942,106	15,984,211
M/C Concurrent	80%	305,466	4.0	1,221,862	\$ 26.00	31,768,422	63,536,845
Non M/C		<u>893,941</u>	4.0	<u>3,575,764</u>	\$ 33.25	<u>118,894,153</u>	<u>237,788,306</u>
		1,275,773		5,103,092		158,604,681	317,229,362
<b>Projected Pricing and Volumes</b>							
M/C One to One	20%	76,366	3.60	274,919	\$ 26.00	7,147,895	14,295,790
M/C Concurrent	80%	305,466	1.00	305,466	\$ 18.00	5,498,381	10,996,762
Non M/C One to One	90%	804,547	3.60	2,896,369	\$ 33.25	96,304,264	192,608,528
Non M/C Concurrent	10%	<u>89,394</u>	1.00	<u>89,394</u>	\$ 18.00	<u>1,609,094</u>	<u>3,218,188</u>
		1,275,773		3,566,148		110,559,634	221,119,267
<b>Hospital Outpatient- Decrease in Medicare Net Revenue</b>							<b>54,128,504</b>
<b>Hospital Outpatient- Decrease in Non-Medicare Net Revenue</b>							<b>41,961,591</b>
<b>Hospital Outpatient- Decrease in Total Net Revenue</b>							<b><u>96,090,095</u></b>

**HHEC 02-00774**  
Confidential Treatment  
Requested by HealthSouth Corp

**Projected Effect of Outpatient Reimbursement Changes on Net Revenue**  
**Hospital Outpatient**  
**Proforma 4**

		YTD 6/30/02 <u>Visits</u>	Avg. Billable <u>Units</u>	Total <u>Units</u>	Net Revenue <u>Per Unit</u>	Net Revenue	Annualized Net Revenue
<b>Current Pricing and Volumes</b>							
M/C One to One	20%	76,366	4.0	305,466	\$ 26.00	7,942,106	15,984,211
M/C Concurrent	80%	305,466	4.0	1,221,862	\$ 26.00	31,768,422	63,536,845
Non M/C		<u>893,941</u>	4.0	<u>3,575,764</u>	\$ 33.25	<u>118,894,153</u>	<u>237,788,306</u>
		1,275,773		5,103,092		158,604,681	317,209,362
<b>Projected Pricing and Volumes</b>							
M/C One to One	20%	76,366	3.00	229,099	\$ 26.00	5,956,579	11,913,158
M/C Concurrent	80%	305,466	1.00	305,466	\$ 18.00	5,498,381	10,996,762
Non M/C One to One	85%	759,850	3.00	2,279,550	\$ 33.25	75,795,023	151,590,045
Non M/C Concurrent	15%	<u>134,091</u>	1.00	<u>134,091</u>	\$ 18.00	<u>2,413,641</u>	<u>4,827,281</u>
		1,275,773		2,948,206		89,663,623	179,327,246
<b>Hospital Outpatient- Decrease in Medicare Net Revenue</b>							<b>56,511,136</b>
<b>Hospital Outpatient- Decrease in Non-Medicare Net Revenue</b>							<b><u>81,370,980</u></b>
<b>Hospital Outpatient- Decrease in Total Net Revenue</b>							<b><u>137,882,116</u></b>

**HHEC 02-00775**  
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 Requested by HealthSouth Corp



HEALTHSOUTH Corporation  
 MEETING OF THE BOARD OF DIRECTORS  
 AUGUST 8, 2002  
 MINUTES

Tab 6

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated August 8, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, William T. Owens, President and Chief Operating Officer of the Corporation, John S. Chamberlin, C. Sage Givens, Joel C. Gordon, Charles W. Newhall III, Larry D. Striplin, Jr., George H. Strong and Phillip C. Watkins, M.D. The following guests were also present: Brandon O. Hale, Executive Vice President – Administration and Secretary, Malcolm E. McVay, Executive Vice President and Treasurer of the Corporation, Weston L. Smith, Executive Vice President and Chief Financial Officer of the Corporation, W. Greg Smith, Vice President – Internal Audit of the Corporation, and William C. McGahan, Roderick O'Neill, Scott Wollard and Hugh O'Hare of UBS Warburg LLC. With the exception of Dr. Watkins, everyone was physically present in the Corporation's Board Room. Dr. Watkins participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 11:05 a.m. C.D.T.

**Internal Audit Report**

Mr. Scrusby asked Mr. Greg Smith to give the Board an update on the Corporation's internal audit program. Mr. Smith reviewed with the Board the number and type of audits which had been conducted year-to-date. Mr. Smith also discussed the results of the billing review required by the

*RS - may wish  
with attachment*

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Corporate Integrity Agreement, reviewed the Internal Audit Department's involvement with the HCAR program and responded to questions from the Board.

**Compliance Report**

Mr. Gordon and Mr. Hale presented to the Board an update on the Corporate Compliance Program. Mr. Hale presented statistics from the Compliance Hotline, reviewed the Corporation's compliance training activities and announced to the Board that KPMG had completed its audit of year one under the Corporate Integrity Agreement and that HEALTHSOUTH had met all requirements of the Corporate Integrity Agreement.

Mr. Gordon advised the Board that the Corporate Compliance Committee was reviewing the gift policy provisions in the Standards of Business Conduct manual and would make a recommendation on revised language at a subsequent meeting.

**Treasury Review**

Mr. McVay presented to the Board a review of Treasury activities. He highlighted the new \$1,250,000,000 bank facility and the refinancing of \$207,000,000 in synthetic leases. He discussed the Corporation's strong liquidity position, indicating that the Corporation had no off-balance sheet financing issues and no significant maturities until 2007. Mr. McVay stated that the Corporation's refinance plan goals had been met. He completed his review with an overview of investor relations issues, including the top ten holders of HRC, current analyst coverage and target list for new coverage.

**Financial Review**

Mr. Smith led the Board through a review of the Corporation's financial performance for the second quarter of 2002. He presented overall results from the income statements and highlighted key financial indicators by operating division.

*Mr. McGahan  
Presentation was poorly  
described and not  
articulate.*

**Chairman's Review**

Mr. Scrushy began his presentation with a brief history of HEALTHSOUTH and its competitors. He then led the Board through an evaluation of the surgery center business and discussed a possible strategy for spinning out or splitting off the surgery division. At that time Mr. Scrushy invited Mr. McGahan and his associates to join the meeting and to present to the Board a detailed analysis of a strategic plan to spin or split the surgery division (Project Crimson). In addition to the analysis provided by UBS Warburg, Mr. Scrushy presented to the Board a proposed management structure for the surgery company and identified individuals for all key executive positions. Mr. Scrushy also stated his desire to move into the Chairman of the Board position of both HEALTHSOUTH and the new surgery company, and recommended William T. Owens be promoted to Chief Executive Officer of HEALTHSOUTH, such promotion to be effective at such time as the Board approved a plan with respect to the surgery division. Mr. Scrushy also recommended that Malcolm E. McVay be promoted to Chief Financial Officer in order to allow Weston L. Smith to focus all of his attention on the proposed surgery center transaction.

Upon motion duly made by Mr. Striplin and seconded by Mr. Chamberlin, the following resolution was unanimously adopted:

RESOLVED, that the following persons are hereby appointed to the offices set forth following their names below, to serve until the next Annual Meeting of the Board of Directors of this Corporation and until their successors are duly elected and qualified, or until their earlier death, resignation or removal, such appointment to be effective at such time as the Board of Directors give preliminary approval to a strategic transaction involving the Corporation's surgery center division, or as otherwise directed by the Board of Directors:

<u>Name</u>	<u>Title</u>
William T. Owens	President and Chief Executive Officer
Malcolm E. McVay	Executive Vice President and Chief Financial Officer

Mr. Scrushy then advised the Board that the Corporation had obtained a copy of a CMS transmittal which appeared to change regulations for payment of group and concurrent therapy for outpatient medicare reimbursement. Mr. Scrushy stated that the Corporation's reimbursement

department was initially advised by Blue Cross/Blue Shield of Alabama, the Corporation's Medicare intermediary, that the transmittal did not apply to HEALTHSOUTH's outpatient therapy business. Mr. Owens then joined the discussion and advised the Board that in seeking additional clarification to the transmittal, HEALTHSOUTH reimbursement officials scheduled a meeting with CMS in Washington in July, and after that meeting reimbursement officials left Washington with more questions than answers and were still unclear of the intent and possible impact of the transmittal.

Mr. Scrusby advised the Board that the Corporation was still seeking answers and clarification so as to assess the impact on revenue and announce it if necessary. Mr. Scrusby recommended, and the Board concurred, that management should again meet with CMS in Washington as soon as possible to obtain further clarification and assess the impact on the Corporation.

Mr. Scrusby then advised the Board that he had repaid his loan under the 1999 Executive Loan Plan by transferring to the Company HEALTHSOUTH shares with a value equal to the principal amount of the loan and paying interest owed in cash.

There being no further business to transact, the Meeting was adjourned.

  
\_\_\_\_\_  
Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

  
\_\_\_\_\_  
Richard M. Scrusby  
Chairman of the Board  
and Chief Executive Officer

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**CONFIDENTIAL  
TREATMENT REQUESTED  
HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
AUGUST 26, 2002  
MINUTES**

Tab 7

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated August 26, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, William T. Owens, President and Chief Operating Officer of the Corporation, Joel C. Gordon, Phillip C. Watkins, M.D., Larry D. Striplin, Jr., George H. Strong, John S. Chamberlin and C. Sage Givens. The following guests were also present: Brandon O. Hale, Executive Vice President – Administration and Secretary, Malcolm E. McVay, Executive Vice President and Treasurer of the Corporation, Weston L. Smith, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, and Larry D. Taylor, President and Chief Operating Officer – Ambulatory Services of the Corporation, William McGahan, Rod O'Neill, Hugh O'Hare, Scott Wollard, John Wagner and Rick Leaman of UBS Warburg, LLC, and Samuel H. McGarr and Tom Avent of KPMG. With the exception of Mr. Leaman, everyone was physically present in the Corporation's Board Room. Mr. Leaman participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 4:00 p.m. C.D.T.

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Project Crimson Strategic Alternatives Discussion

UBS Warburg Presentation

Mr. Scrushy asked Mr. McGahan and his associates to lead the Board through a strategic alternative discussion on Project Crimson. UBS Warburg began with a review of a segment valuation and a discussion of ways to improve business focus by considering several alternatives, including the sale of the diagnostic facilities combined with the split off of the surgery centers, the sale of the surgery centers, the spin-off or split-off of the surgery centers (with or without IPO) and the sale of the diagnostic facilities. UBS Warburg then presented to the Board a debt analysis and discussed how the current debt profile impacted the alternatives being considered. In closing, Mr. McGahan and the UBS Warburg team presented a summary of the timeline of events to take place and led a discussion of the key separation decisions that needed to be made by the Corporation.

KPMG Opinion

Mr. Scrushy requested Mr. McGarr and Mr. Avent give their opinion on whether there is a justifiable business reason for either the spin off or split-off of the surgery division, thus allowing a tax-free transaction. Mr. Avent responded that he is very comfortable that there are several justifiable business reasons for the spin-off or split-off transaction which would allow a tax-free transaction to be effected.

**CMS Transmittal 1753**

Mr. Scrushy asked Mr. Owens to review with the Board the timeline of events resulting from CMS Transmittal 1753. Mr. Owens stated that CMS Transmittal 1753 was posted to Part B carriers only on May 17, 2002 and the Corporation received a copy of the Transmittal from a third party in early June. The Corporation forwarded a copy to Blue Cross of Alabama (the Corporation's fiscal intermediary), who advised the Corporation that the Transmittal did not apply to HEALTHSOUTH. The Corporation requested a formal letter from Blue Cross of Alabama. After not having received one, a meeting was scheduled for July 18, 2002 with CMS and reimbursement representatives from HEALTHSOUTH. That meeting generated more questions than answers. Mr. Owens stated that he had believed the Transmittal might apply to the Corporation's outpatient services in freestanding

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outpatient centers. He informed Mr. Scrusby on August 6 that it might apply to such services in freestanding outpatient centers and the impact could be \$15,000,000 - \$20,000,000. Mr. Scrusby stated that he had advised Mr. McVay and subsequently Mr. Owens to go back to CMS for better clarification. The meeting on August 15 did not answer all questions regarding Transmittal 1753, but answered enough questions to allow the Corporation to prepare an analysis of the potential impact.

Mr. Owens advised the Board that he was comfortable with the chronology of events and that the Corporation had been working diligently since the August 15 meeting to assess the impact of the Medicare changes.

Mr. Scrusby and Mr. Owens advised the Board that the estimated impact on revenue of CMS Transmittal 1753 would be \$175,000,000 per year, and that the Corporation would be putting out a press release disclosing this on Tuesday, August 27.

**SCA Update**

Mr. Taylor thanked Messrs. Scrusby and Owens and the Board for their support and made comments regarding SCA's management team and updated the Board on current initiatives and development activities.

All guests left the room at this time for the Board to continue discussions regarding Project Crimson and CMS Transmittal 1753. After discussions, the Board, upon motion duly made and seconded, gave preliminary approval to management to proceed with development of a plan for a separation transaction involving the surgery center division. There were no votes cast against the motion. It was noted that the promotions and responsibility changes involving Mr. Owens, Mr. Smith and Mr. McVay that were approved at the August 8 meeting would become effective as of this meeting.

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There being no further business to transact, the Meeting was adjourned.

  
Richard M. Scrusby  
Chairman of the Board

HS-71307.1

  
Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

**The Gordon Group**

3102 West End Avenue, Suite 650 • Nashville, Tennessee 37203 • (615) 385-3541 • Fax (615) 298-6641

August 30, 2002

Mr. Richard Scrusby  
Chairman and CEO  
HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, Alabama 35243

Tab 8

Dear Richard:

I am writing to request any additional information that might be available in regard to Project Crimson and the business rationale underlying the proposal. Based on the information provided by UBS Warburg, I remain unconvinced that this is the best route to maximize shareholder value, as you no doubt surmise from my comments during the board meeting and my abstention on the vote with regard to this matter at the August 26, 2002 board of directors meeting.

I look forward to receiving additional information about the proposed plan, including information about the expected strategic direction of each company, the nature of and terms of the expected future business relationships between the two companies, the management structure of each company, the capital structure and capital resources of each company, and said other information as may be necessary to fully inform me in connection with the prospective vote on the proposed plan.

While I am sure the requested information will be available in the near future regarding the matters set forth above, I would appreciate hearing any thoughts that might currently be available. Further information would certainly help me become better informed about the matters which will be under future consideration.

Sincerely



Joel C. Gordon

cc: William Horton, Legal Department

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HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
SEPTEMBER 17, 2002  
MINUTES

Tab 9

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated September 17, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., C. Sage Givens, Charles W. Newhall III, Larry D. Striplin, Jr. and Joel C. Gordon. The following guests were also present: Larry D. Taylor, President and Chief Operating Officer — Surgery Center Operations of the Corporation, Patrick A. Foster, President and Chief Operating Officer — Inpatient Services of the Corporation, Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Weston L. Smith, Executive Vice President of the Corporation, Daniel J. Riviere, President — Ambulatory Services of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, Susan Smith, Senior Vice President — Reimbursement of the Corporation, Jean Davis, Vice President — Operations of the Corporation, Eric R. Hanson of U.S. Strategies, William C. McGahan and Benjamin D. Lorello of UBS Warburg LLC, J. Michael Rediker and Thomas L. Krebs of Haskell Slaughter Young & Rediker, Lanny J. Davis, Debra M. Laboschin and Raphael Larson of Patton Boggs, LLP, Michael Deaver of The Edelman Group, and Thomas C. Fox and Scot T. Hasselman of Reed Smith LLP. With the exception of Messrs. Hanson, Davis and Deaver, all Directors and guests were physically present in the Board Room. Messrs. Hanson, Davis and Deaver participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

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The Meeting was called to order by Mr. Scrusby at 2:35 p.m. C.D.T.

**SCA Update**

Mr. Taylor provided the Board with an update on surgery center separation activities. He reviewed the new SCA logo, the Mission Statement and the organizational structure. He also outlined several other key initiatives critical for success.

**CMS Regulations Review**

Mr. Owens introduced Ms. Smith and Ms. Davis and asked them to present a history of CMS activity from 1998 to the present with regard to reimbursement for concurrent or group therapy provided by physical therapists. Ms. Smith and Ms. Davis presented a detailed history using correspondence from CMS and documentation from HEALTHSOUTH and HEALTHSOUTH's reimbursement counsel regarding outpatient therapy reimbursement issues.

Mr. Owens also introduced Matt Zurek, Regional Vice President — Operations, and Rob Tillman, Vice President — Clinical Development, both physical therapists. Messrs. Zurek and Tillman discussed with the Board how physical therapists within the industry treat patients with regard to concurrent and group therapy. Both felt that HEALTHSOUTH's practices were consistent with the industry and what is taught in the physical therapy schools.

At this point Mr. Lanny Davis of Patton Boggs joined the meeting via telephonic connection. Mr. Davis and his firm were hired by the Corporation to consult on legal and media relations matters facing the Corporation. Mr. Davis spent several minutes discussing strategy and the scope of his firm's involvement.

Mr. Rediker and Mr. Krebs discussed with the Board the strategy for defending the shareholder and derivative lawsuits. Mr. Rediker stated that the cases were winnable and the Corporation should be aggressive with a proactive strategy which could produce newsworthy developments.

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**Corporate Compliance**

Mr. Gordon advised the Board that he and Messrs. Watkins and Newhall had a telephone conference on September 13, 2002 to discuss the need for an independent investigation of allegations of insider trading and improper disclosure. Mr. Gordon recommended the firm of Wilmer, Cutler & Pickering and Mr. Newhall recommended the firm of Fulbright & Jaworski, L.L.P. to conduct the independent investigation on behalf of the Board.

Mr. Scrusby asked Mr. Rediker to comment on the independent investigation and to give the Board recommendations on other matters to consider. Mr. Rediker recommended the Board establish a special litigation committee of the Board of Directors, comprised of independent directors to investigate the derivative lawsuits. This committee would conduct their investigation concurrent with the independent investigation conducted by an outside law firm. To establish a special litigation committee, Mr. Rediker advised the Board that it would need to add an additional outside director who met the test of independence.

After discussion, upon motion duly made by Mr. Chamberlin and seconded by Dr. Watkins, the following resolution was unanimously adopted:

RESOLVED, that the number of Directors constituting the whole Board of Directors shall be ten.

There after, upon motion duly made by Dr. Watkins and seconded by Mr. Chamberlin, the following resolution was unanimously adopted:

RESOLVED, that Jon F. Hanson is hereby appointed to serve as a Director of this Corporation until the next Annual Meeting of Stockholders of this Corporation and until his successor is duly elected and qualified, or until his earlier death, resignation or removal.

After discussion of the special litigation committee and the independent investigation, Mr. Davis stated that he felt Fulbright & Jaworski would be the better choice to conduct the independent investigation.

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After further discussion, upon motion duly made by Dr. Watkins and seconded by Ms. Givens, the following resolutions were unanimously adopted:

RESOLVED, that having considered the claims made by Wade Tucker, purporting to be a shareholder, against the Company, Richard M. Scrusby, an officer and director of the Company, Gerald P. Scrusby, MedCenterDirect.com, Source Medical Solutions, Inc., Capstone Capital Corporation, and G.G. Enterprises. Case No. CV02-5212, Circuit Court of Jefferson County, Alabama, filed August 28, 2002 without prior demand on the Company's Board of Directors, in the form of a derivative action (the "Tucker Action"), and taking into consideration the Company's plans to move to dismiss or stay the Tucker Action, and desiring to preserve to the Company and the Board to pursue such motions to dismiss or stay while otherwise delegating to an appropriate committee the powers and discretions to conduct the review of the Tucker Action and any related matters and issues as set forth below, the Board of Directors hereby constitutes and appoints a Special Litigation Committee (the "Committee"), which will consist initially of existing director Larry D. Striplin, Jr. and new director Jon Hanson (and, subsequently, of such additional independent directors, if any, as the Board of Directors may appoint from time to time), to investigate, review and analyze: (1) the facts, transactions, events and circumstances surrounding the claims made in such Tucker Action and any other actions or proceedings which may be filed which relate or are alleged to relate to any event or transaction which is a subject in or of the Tucker Action; and (2) to the extent the Business Judgment Rule may be determined to be applicable thereto or to the extent claims of a derivative nature may be asserted in respect thereto, any events or transactions which are or may become the subject of any of the pending federal court class actions which have been filed against the Company since August 27, 2002 in the United States District Court for the Northern District of Alabama.

FURTHER RESOLVED, that such Committee shall consider and determine whether or not prosecution or continuation of such claims and actions is in the best interests of the Company and its shareholders, and what action the Company should take with respect thereto;

FURTHER RESOLVED, that such Committee is hereby authorized and directed to continue in existence until such time as the Committee shall recommend its dissolution to the Board of Directors, and to engage such experts and advisers, including independent legal counsel, as the Committee shall deem necessary or desirable in order to assist it in the discharge of its responsibilities;

FURTHER RESOLVED, that the Committee shall have and may exercise in connection with its investigation and determination all the powers and authority of the Board of Directors, which is hereby delegated to the Committee, and such other powers as are accorded to such a committee under applicable law;

FURTHER RESOLVED, that nothing herein is intended to moot or waive the Company's planned motions to dismiss or stay the Tucker Action for lack of standing

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and/or failure to state a claim upon which relief may be granted and failure to comply with the requirements of Rules 12(b)(6) and 23.1, Alabama Rules of Civil Procedure; provided, however, that the Committee shall have full power and discretion to recommend that any Company motion or pleading be changed, withdrawn, or supplemented by additional or substituted pleadings or motions of the Committee or the Company, or both, as shall be deemed appropriate;

FURTHER RESOLVED; that the determinations made by the Committee shall be final, shall not be subject to review by the Board of Directors and shall in all respects be binding upon the Company;

FURTHER RESOLVED, that the officers, agents, and employees of the Company, and each of them, are hereby authorized and directed to assist the Committee and to provide it with all information and documents that it shall request with respect to the subject matter of the Tucker Action and any actions or proceedings related to the subject matter of the Tucker Action, having due regard for any applicable privileges.

After further discussion, upon motion duly made by Dr. Watkins and seconded by Ms. Givens, the following resolutions were unanimously adopted:

RESOLVED, that this Corporation is authorized to engage the services of Fulbright & Jaworski, LLP to conduct a review of such matters relating to pending litigation and investigations regarding this Corporation as may be directed by the Board of Directors and encompassed in one or more engagement letters executed between this Corporation and Fulbright & Jaworski, LLP.

RESOLVED, that any reports or other work product created by or at the direction of Fulbright & Jaworski, LLP pursuant to the foregoing resolution shall be made available to the Special Litigation Committee as it may request.

Mr. Striplin then affirmed that he has no financial relationship with Mr. Scrusby and was not an investor in MedCenterDirect, Source Medical or Capstone Capital.

**CEO Report**

Mr. Owens updated the Board on operational and financial results to date for the current quarter. He also discussed with the Board the Corporation's decision to suspend guidance at the present time.

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**UBS Warburg Comments on Surgery Center Transaction**

Messrs. McGahan and Lorello reviewed in detail with the Board current issues surrounding the spin or split of the surgery division.

**Confidentiality Statement**

Mr. Rediker stated to the Board and to agents of the Board participating in the meeting the importance of confidentiality and the nature of insider information being shared and discussed.

**Review of Investor Conference Call**

Messrs. Scrushy and Davis reviewed with the Board the key components of the investor conference call scheduled for September 19, 2002.

**Other Matters**

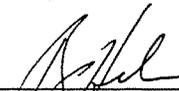
At the close of the Meeting, Hal Hirsch of Fulbright & Jaworski joined the meeting via telephonic connection to accept the assignment to conduct the independent investigation and confirmed that Fulbright & Jaworski had no prior involvement with the Corporation.

Mr. Gordon discussed with the Board his views on the role of the Compliance Committee in regard to the investigation by Fulbright & Jaworski and his desire that the Compliance Committee and the full Board be kept informed of all relevant information on a current basis.

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrushy  
Chairman of the Board



Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

HS-71515.1

B00

9/19/02

**HHEC 293-0319**  
Confidential Treatment  
Requested by HealthSouth Corp.

BOD  
9/17/02

Pres WTD PCW ~~OK~~  
CSG CUN JSC JCG LRS

Guids T. McVay, W. Smith, L. Taylor  
D. Acker, L. Fisher, B. Brinson  
B. Hunter Eric Hansen  
Bill McGowan, Ben Lucella

start 2:35 PM

Mike Rediker, Tom Kieck  
& others

Surgery Separation Progress - Larry Taylor

- New logo - stam
- Mission Statement
- Location Map -> 37 slides
- 212 Total Locations
- Executive Management Team
- Service Management Team
- Field Managers
- Development Team
- Strong Budget Leads
- Resynchronization Process
- Surgery Center Case Mix
- Health Information Services

Clinical Services

Managed Care Contracting

Dedicated Sales Force

Physician Advisory Boards

Professional Boards

Surgical Benchmarks

Corporate Benchmarks

Regional Clinical Excellence

Recap of Marketing Meetings

SEC Preparation

Shared Services

Competition

Summary

~~Bill Gross~~

→ Review of History

- CMS Regulations relative to concurrent therapy + group therapy  
(Same Smith, Jean Davis, Tom Fox with Paul Smith, Matt Zwick + Rob Tillman (+ Scott + Huselman))

~~Product~~  
~~History~~

See

History from 1998 to present on CMS Regulations  
HealthSouth's position has been the same  
we have been firm + consistent

James

HHEC 293-0321  
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Requested by HealthSouth Corp.

April 1999 Draft Program Approval Memorandum

April 1998 notes from Jean Davis (transcript)

March 2000 Program Memorandum - Final

Susan Henry  
2 attorney  
meeting  
+ joint the  
Defendant  
Retired

April 5 2001 Web site  
Federal Register May 2001

\* July 31 2001 Fed Reg  
May 17 2002 Transmittal

Kevin Davis  
Attorney  
the case

HealthSouth got copy since 6 from our attorney

Book 2

January - Susan Jones Memo to Bill Hahn

June 25 - Susan Jones Memo to Dr. McKinnay

June 28 - Dr. McKinnay response

July 12 - Letter to Tom Grison from Echeverria

July 19 - Meeting with Jean Davis, Steve Sped and  
Tom Grison with CMS

August 7, Memo to Tom Grison from Jean Davis

August 15<sup>th</sup> Meeting with Tom Grison, Susan Jones,  
Jean Davis, Larry Taylor and Matt Zurwit

August 16 - Reported by to wife that 1728 applied to  
IP as well as OP therapy

Tom Fox - <sup>RedSmith</sup> legal opinion issued Nov 2000  
update on legal position - Fed Reg  
is in very good position to defend

Matt Zurwit & Rob Telleen - Discussed actual  
practices of PT's within HealthSouth  
and throughout the industry

Model Demos - Address

Mike Demer - via telephone  
Sally Powell - Not on call  
Larry Davis - via telephone

Larry Davis

Discussed in general his involvement in  
the legal + posturing of HealthSouth legally  
and personally toward the Media

Introduction of Mike Demer

Presentation by Mike Rediker + Tom Krebs

Discussed strategy of dealing  
shareholder lawsuits + derivative lawsuits

5:05 - Break For Dinner

6:00 - Re-convene

(with regard to Debra's law)

Mike Rediker - This case is winnable  
and the Company should be  
aggressive - with proactive strategy  
which could produce some news worthy  
developments

Joel Gordon - Called Dept and asked if  
Compliance Committee should investigate  
Dept sent no

Compliance Committee Recommendations

- Gordon Feels the Compliance Committee has the responsibility to investigate the allegations

RMS asked Mike Reiter to give Board recommendation on how to address what Gordon is recommending

? (Mike Reiter)

- 1) Board can decide whether to make change
- 2) Fidelity rule

[Get explanation from Gordon]

Recommendations Special Litigation Committee (SLC)

- ① No financial interest in transaction
- ② Don't report to those whose interests caused lawsuit
- ③ Thorough in investigations
- ④ Requires action of entire Board

Fulbright & Jaworski

Larry Davis Feels that Fulbright & Jaworski would be the better choice than Wilmer, Cutler

Action to increase size of Board ① children ② with

Name Tom Hanson to Board ① with ② child

① Stephen Affirmation that he has no  
 financial relationship with Rishel &  
 not involved in ACO/Source/Logster

Motion for adoption of resolution to set up SEC  
 @ Vetter  
 @ Green

CEO Presentation - WTD - update on Qtr

- Discussion of why we suspended guidance
- Discussion of when we are quarter to date

- Complexity of establishing exact effect of  
 transition on all non-medical contracts

Estimate of quarter was \$ .28  
 impact                    .08  
                                    .20

Base Minimum \$ .11  
 of Sept strong \$ .20

Cash collections strong  
 DSO's should be improving

UBS Warburg Bill McGraw / Ben Lonillo

Issues

- ① Spin vs split
- ② Stock Price
- ③ Strong EBITDA
- ④ Bonds

Analysis →

Why Buy Stock Price

- ① Fear that bank rebrand to 1997
- ② Litigation - worried re. loan & wh
- ③ Access to capital
- ④ ongoing probability of what business

Opportunity

→ Effect on Share Price

\* Mike Redden of the board  
 Statute to Board & Agents  
 on insider information and  
 importance of confidentiality

RMS Review of Thursday Conference Call

~~Friday~~

Hal Horch - Fulbright + Jaramila - accepted the assignment

Artie Reiter discussed resolution with Hal on resolution passed by Board

↳ Confirmed no prior involvement with Company or part of Fulbright + Jaramila

Review of Conference Call

Key Concepts by Larry Davis

- ① Get beyond rules
- ② Fairness
- ③ Guilt by association - disprove
- ④ RMS be very personal + direct
- ⑤ Commitment to transparency

→ See Gordon comments about being set up by other board members H

Alison 8:20 PM - Discussion  
- RMS Comments

**RESOLUTION APPOINTING SPECIAL LITIGATION COMMITTEE**

RESOLVED, that having considered the claims made by Wade Tucker, purporting to be a shareholder, against the Company, Richard M. Scrushy, an officer and director of the Company, Gerald P. Scrushy, MedCenterDirect.com, Source Medical Solutions, Inc., Capstone Capital Corporation, and G.G. Enterprises, Case No. CV02-5212, Circuit Court of Jefferson County, Alabama, filed August 28, 2002 without prior demand on the Company's Board of Directors, in the form of a derivative action (the "Tucker Action"), and taking into consideration the Company's plans to move to dismiss or stay the Tucker Action, and desiring to preserve to the Company and the Board to pursue such motions to dismiss or stay while otherwise delegating to an appropriate committee the powers and discretions to conduct the review of the Tucker Action and any related matters and issues as set forth below, the Board of Directors hereby constitutes and appoints a Special Litigation Committee (the "Committee"), which will consist initially of existing director Larry D. Striplin, Jr. and new director John Hanson (and, subsequently, of such additional independent directors, if any, as the Board of Directors may appoint from time to time), to investigate, review and analyze: (1) the facts, transactions, events and circumstances surrounding the claims made in such Tucker Action and any other actions or proceedings which may be filed which relate or are alleged to relate to any event or transaction which is a subject in or of the Tucker Action; and (2) to the extent the Business Judgment Rule may be determined to be applicable thereto or to the extent claims of a derivative nature may be asserted in respect thereto, any events or transactions which are or may become the subject of any of the pending federal court class actions which have been filed against the Company since August 27, 2002 in the United States District Court for the Northern District of Alabama.

FURTHER RESOLVED, that such Committee shall consider and determine whether or not prosecution or continuation of such claims and actions is in the best interests of the Company and its shareholders, and what action the Company should take with respect thereto;

FURTHER RESOLVED, that such Committee is hereby authorized and directed to continue in existence until such time as the Committee shall recommend its dissolution to the Board of Directors, and to engage such experts and advisers, including independent legal counsel, as the Committee shall deem necessary or desirable in order to assist it in the discharge of its responsibilities;

FURTHER RESOLVED, that the Committee shall have and may exercise in connection with its investigation and determination all the powers and authority of the Board of Directors, which is hereby delegated to the Committee, and such other powers as are accorded to such a committee under applicable law;

FURTHER RESOLVED, that nothing herein is intended to moot or waive the Company's planned motions to dismiss or stay the Tucker Action for lack of standing and/or failure to state a claim upon which relief may be granted and failure to comply with the requirements of Rules 12(b)(6) and 23.1, Alabama Rules of Civil Procedure; provided, however, that the Committee shall have full power and discretion to recommend that any Company motion or pleading be changed, withdrawn, or supplemented by additional or substituted pleadings or motions of the Committee or the Company, or both, as shall be deemed appropriate;

FURTHER RESOLVED; that the determinations made by the Committee shall be final, shall not be subject to review by the Board of Directors and shall in all respects be binding upon the Company;

FURTHER RESOLVED, that the officers, agents, and employees of the Company, and each of them, are hereby authorized and directed to assist the Committee and to provide it with all information and documents that it shall request with respect to the subject matter of the Tucker Action and any actions or proceedings related to the subject matter of the Tucker Action, having due regard for any applicable privileges.

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**HEALTHSOUTH Corporation**  
**MEETING OF THE BOARD OF DIRECTORS**  
**OCTOBER 1, 2002**  
**MINUTES**

Tab 10

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 1, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrushy, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Charles W. Newhall III, Larry D. Striplin, Jr., Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, Eric R. Hanson of U.S. Strategies, Michael Rediker of Haskell Slaughter Young & Rediker, Hal M. Hirsch of Fulbright & Jaworski, L.L.P., and Lanny J. Davis of Patton Boggs, LLP.

Richard M. Scrushy acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrushy at 12:25 p.m. C.D.T.

**Surgery Divestiture Update**

Mr. Owens advised the Board that management gave a high-level presentation to a group of interested buyers in New York in a meeting arranged by the bankers. The Corporation is gauging the level of interest and will provide additional information to serious buyers. Mr. Owens stated that

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the Corporation had not abandoned the split/spin strategy of the surgery division, but that it should evaluate other options if any develop.

#### **Lawsuit Update**

Mr. Rediker provided the Board with an update on the various shareholder lawsuits. He advised that the Corporation filed answers in 14 cases on September 30.

#### **Fulbright & Jaworski Update**

Mr. Hirsch presented to the Board a preliminary report of Fulbright & Jaworski's review of the Corporation's disclosures and related events surrounding CMS Transmittal 1753. Mr. Hirsch read a proposed letter to the Board, a copy of which is incorporated into these minutes. Mr. Hirsch then entertained questions from the Board.

Mr. Davis at that point added that he had agreed to undertake the assignment with HEALTHSOUTH only with the understanding that he must have complete transparency. Mr. Davis stated that he felt the Corporation had been completely open and transparent and at this point in time Fulbright & Jaworski had found nothing to indicate that Mr. Scruschy knew anything about the impact of CMS Transmittal 1753 at the time of his stock transactions in May and July 2002.

#### **Appointment of Corporate Governance Committee**

Mr. Scruschy proposed that the Board establish a Corporate Governance Committee to be made up of three outside Directors plus a minimum of two reputable independent advisors who are not members of the Board. The Directors serving on the Committee would make recommendations for such independent advisors, to be submitted to the full Board for approval. After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Striplin, the following resolutions were unanimously adopted:

RESOLVED, that the following persons are hereby appointed to the Corporate Governance Committee of the Board of Directors, each to serve until the next Annual Meeting of the Board of Directors of this Corporation and until his

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successor is duly appointed and qualified, or until his earlier death, resignation or removal:

Robert P. May  
Jon F. Hanson  
John S. Chamberlin

RESOLVED, that the foregoing members of the Corporate Governance Committee shall consider and recommend to the Board of Directors of the Corporation for approval at least two independent persons who are not Directors, officers or employees of the Corporation to serve on the Corporate Governance Committee as special advisors.

**Special Litigation Committee**

Mr. Striplin advised the Board that he had resigned as Chairman of the Special Litigation Committee and that Mr. May had been elected to replace him. Mr. May then reported to the Board that the Special Litigation Committee had engaged Balch & Bingham LLP to serve as its counsel, would meet with counsel, and would keep the Board informed through routine reports to the Board.

**Compensation Committee**

Mr. Striplin advised the Board that the Compensation Committee recommended the following compensation for the Special Litigation Committee: \$25,000 per year retainer, \$2,500 for in-person Committee meetings and \$1,000 for telephone Committee meetings.

Upon motion duly made by Mr. Striplin and seconded by Mr. Newhall, the following resolution was unanimously adopted:

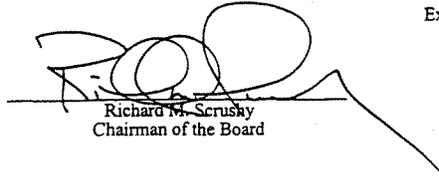
RESOLVED, that compensation for the Special Litigation Committee of the Board of Directors is hereby set at a retainer of \$25,000 per year, plus a fee of \$2,500 for in-person meetings of the Special Litigation Committee and \$1,000 for telephonic meetings of the Special Litigation Committee.

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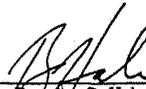
**Investor Relations Update**

Mr. McVay advised the Board that the Corporation was in the process of reviewing its investor relations function with the objective of improving effectiveness, particularly with the major 100 investors. Mr. McVay stated that he would provide the board with more information at a subsequent Board meeting.

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrusky  
Chairman of the Board



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Braden O. Hale  
Executive Vice President - Administration  
and Secretary

**JOEL C. GORDON**

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3102 West End Avenue, Suite 650  
Nashville, TN 37203  
(615) 385-3541  
Fax: (615) 298-5641

Tab 11

**FAX TRANSMISSION COVER SHEET**

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TO: WILLIAM HORTON  
FROM: JOEL GORDON  
FAX #: (205) 969-4730  
DATE: OCTOBER 8, 2002  
SUBJECT:

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You should receive 5 page(s), including this cover sheet. If you do not receive all the pages, please call Judy Ernst at (615) 385-3541.

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254-1490

**HHEC 355-0062**  
Confidential Treatment  
Requested by HealthSouth Corp.

Oct 08 02 11:20a

P. 2

Joel C. Gordon  
6408 East Valley Court  
Nashville, Tennessee 37205

*Sent Via Facsimile and United Parcel Service*

October 8, 2002

Richard M. Scrushy  
HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

I am writing to address certain concerns that I continue to have following our recent board meetings. As you are aware, I called a meeting of the Corporate Compliance Committee on September 13, 2002, to consider appropriate actions by the Committee. At that meeting, it was the consensus of the Committee that the Committee conduct an investigation, through the engagement of independent counsel.

During that meeting, we determined to seek the view of Mr. Horton, the Company's corporate counsel, as to whether or not two firms recommended by members of the Committee, Wilmer, Cutler & Pickering and Kirkland and Ellis, had any conflict in assisting the Committee in conducting that inquiry. At that time, Mr. Horton stated his view that while he knew of no conflict, he believed that the Committee did not have the power to undertake such an investigation on its own and that it could not retain outside advisors without authorization from the full board of directors. Both I and my counsel disagreed with that view; however, in view of my desire that such an investigation be commenced promptly, I agreed to consult with the other members of the board of directors who were not members of management to determine if they concurred with the Committee's decision. No objections were raised by those members with whom I spoke.

At a meeting of the board of directors held on September 17, 2002, I gave a report to the board regarding the meeting of the Corporate Compliance Committee and our desired course of action. I suggested that the Committee be authorized to retain Wilmer, Cutler & Pickering to assist in conducting the inquiry. One of the other members of the Committee suggested that Fulbright & Jaworski be engaged, and I stated that I did not have a problem with that firm. However, when a member of that firm joined the board meeting by conference call, we were informed that he had been working on this matter for the preceding two days. He also expressed his preliminary views about the likely positive results of the investigation.

**HHEC 355-0063**  
Confidential Treatment  
Requested by HealthSouth Corp.

OCT-08-2002 11:39

95%

P. 02

At our most recent board meeting, I learned that the Company had engaged Fulbright & Jaworski to conduct a review and that it was not to be an independent investigation. The purpose of the Committee's recommendation was to conduct an independent investigation, i.e. one outside the control of management. I might add that I understand Fulbright & Jaworski to be an excellent firm with a fine reputation. My concern goes to the independence of the inquiry.

As I stated to my fellow members of the Corporate Compliance Committee, I believe that it is appropriate to undertake an objective review independent of management to determine if the Company's management acted in compliance with disclosure requirements and if any of the Company's executives who had made sales or other dispositions of Company securities have complied with applicable laws and regulations and with the Company's compliance policies and procedures. I sincerely hope that there has been full compliance but, as a director and Chair of the Corporate Compliance Committee, I need to assure myself that these issues are fully explored and resolved. To accomplish this, I must request the following:

1. As Chairman of the Corporate Compliance Committee, I expect to receive regular updates on the status and results of the Fulbright investigation. I request that the Committee be authorized to engage counsel either to conduct a separate independent investigation or at least to have access to the work performed by Fulbright. Accordingly, I request that you direct Fulbright & Jaworski to consult with that counsel as to their investigative plan. I also expect Fulbright & Jaworski to provide that counsel ongoing access to the information obtained in their investigation.
2. In accordance with the Company's by-laws, notice of any action to be taken at a board meeting should accompany the notice of the time and place of the meeting. I am distressed that members of the board were asked to take actions on several fronts without prior notice of the subject matter thereof or any information about the proposed actions prior to the meeting. While I support the efforts to add additional independent members to the Company's board of directors, I am concerned that the procedures for nominating and electing Mr. Hanson and Mr. May to the board, and the information provided to the Board in that connection, were incomplete. Did the nominating committee of the board of directors consider his qualification and conduct their own review of his independence? Are there any relationships (including any charitable or political contributions) between Mr. Hanson or Mr. May and any of his affiliated entities and the Company or members of its senior management or any of their affiliated entities? Again, I endorse the idea of adding additional independent directors to the Company's board; however, I believe that the board should follow the good corporate governance practices in doing so and

**HHEC 355-0064**  
Confidential Treatment  
Requested by HealthSouth Corp.

Oct 08 02 11:20a

P. 4

look forward to reviewing the work of the new Corporate Governance Committee.

3. To the extent that actions are proposed to be taken by the Board of Directors, I would like to see the exact form of proposed resolutions for such actions as well as detailed information regarding the proposals at least 48 hours in advance of the Board meeting. We need appropriate time to review proposals and information regarding any management proposal.
4. I would like to see drafts of minutes of board meetings or committee meetings within ten days after those meetings are held. I do not believe it is desirable to wait until the next meeting occurs and have the directors consider approval at the meeting without opportunity for prior review. To be certain my records are complete, please send me immediately all approved board and committee minutes from January 1, 2002 to date.
5. I understand that the SEC has given the Company notice of an investigation and the media has reported that the investigation focuses on accounting matters as well as trading activity. I also understand that the Company has engaged Patton and Boggs to represent it in connection with the investigation. This investigation is of obvious importance to the Company and I request the following information.
  - a. a copy of the SEC notice of investigation and of any future letters or document requests or subpoenas from the SEC as well as any responses by the Company to those letters or requests;
  - b. a copy of the engagement letter of Patton and Boggs;
  - c. a written statement describing any verbal comments received from the staff of the SEC regarding the scope of matters under review by them, including whether the conduct of any individual, executive officer or director of the Company is a subject of any document or informational request;
  - d. confirmation that the Corporate Compliance Committee will receive copies of information provided to the SEC and that Patton and Boggs will keep the Committee informed regarding the status of the SEC investigation, including any change in the scope of their investigation or any additional issues identified for investigation by the staff of the SEC; and
  - e. a copy of the Company's current document retention policy.

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P. 04

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p. 5

I hoped that my requests are clear. If they are not, please do not hesitate to contact me.

Sincerely,



Joseph C. Gordon

cc: William W. Horton ✓  
Brad Hale  
Harry Weiss – Wilmer, Cutler & Pickering

**HHEC 355-0066**  
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Requested by HealthSouth Corp.

OCT-08-2002 11:41

95%

P. 05

Joel C. Gordon  
6408 East Valley Court  
Nashville, Tennessee 37205

October 8, 2002

Tab 12

Phillip C. Watkins, MD  
MVP Physicians Group  
880 Montclair Road, Suite 370  
Birmingham, AL 35213

Dear Phil:

I wanted to write to you after our recent Board meeting to express my concerns arising from the events of last week. As Chairman of the Corporate Compliance Committee, I called a meeting of that Committee to consider whether or not the Committee should conduct a review of certain issues relating to public disclosures made by the Company and sales or other dispositions of securities by Company executives. I believe that it is appropriate to conduct a thorough and objective inquiry into these matters.

I enclose a copy of my letter to Mr. Scrusby in which I outline certain actions I expect to take and my expectations for information, which I expect to be provided as a member of the Board of Directors and as Chair of the Committee. Given the actions taken by the management without any prior knowledge or action of the Board, I feel it is necessary to take certain actions to assure that there is a fair and complete review of the matters under investigation and of concern to the Compliance Committee.

I and my family are large, if not the largest non-institutional, shareholders in this Company. Our Company's business is dependent upon having outstanding and credible relationships with government entities. It is my desire to see that those relationships are not damaged. I am unwilling to participate in the further erosion of our Company's credibility. To that end, I have retained Wilmer, Cutler & Pickering as counsel to assist me as Chair of the Compliance Committee in this matter. I have sought additional information from the Company regarding a number of matters related to the Committee's responsibilities. I have requested that we receive notice of and information regarding actions that we are asked to take in advance of the meetings where we will consider them.

As you are also aware from our previous board meetings, I am skeptical of management's plan to split off the surgery center business as a separate company. I am concerned about how our shareholders will be treated; about our responsibilities to determine that newly created companies be adequately and fairly capitalized; and about the personal benefits that might accrue to members of management in connection with any transaction.

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PW 0000061

I intend to work to preserve and enhance the value of the investment of our company's shareholders. My hope is that we can repair the Company's credibility with government entities and the capital markets. If we focus on satisfying our duties to our shareholders, I am confident we can do so.

Sincerely,



Joel C. Gordon

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PW 000062

10/15/2002 17:38 FAX

002/004



Tab 13

2550 M Street, NW  
 Washington, DC 20007-1750  
 202-457-6000

Facsimile 202-457-8315  
 www.pattonboggs.com

**VIA FACSIMILE NO.: (615) 298-5641 & FEDERAL EXPRESS**

October 15, 2002

Mr. Joel C. Gordon  
 6408 East Valley Court  
 Nashville Tennessee 37205

**Re: Your Letter of October 8, 2002 to Richard M. Scrushy**

Dear Mr. Gordon:

I have been asked to respond to your letter of October 8, 2002 to Richard M. Scrushy, Chairman of HealthSouth Corporation. I understand you have sent a separate letter to one or more members of the Board enclosing a copy of your letter to Mr. Scrushy.

If you are already represented personally by counsel regarding this matter, please pass this letter on to him/her and ask him/her to call me whenever practicable. When I use the word "you" in this letter, I am referring to you and/or your counsel.

For your convenience, in communicating my response, I will refer to each of your requests by the same numbering you used in your October 8 letter.

1. As Chair of the Corporate Compliance Committee, you have asked for the Company to authorize the CCC to retain its own counsel, either to conduct a separate investigation of the same matters currently under investigation by Fulbright & Jaworski ("F&J"), or at least to have access to their completed and ongoing work. I am assuming that by this you mean that the Company should pay for such separate counsel. Respectfully, in my judgment, the Company should reject your request as an unnecessary use of corporate resources.

To remind you, at its September 13, 2002, meeting, the Board of Directors of HealthSouth determined that F&J should be retained to conduct an "outside review" pertaining to various issues in connection with the Company's press release of August 27, 2002, including when Mr. Scrushy first learned of the potential material effect on the Company of the CMS rule change, apparently first transmitted on May 17, 2002. Also at that Board meeting, as you know, the Board authorized the Special Litigation Committee to retain counsel (and the Committee has retained the firm of Balch & Bingham of Birmingham, Alabama) to conduct a separate investigation with respect to issues raised in stockholder derivative suits filed in Alabama (and subsequently in Delaware).

Washington DC | Northern Virginia | Dallas | Denver | Boulder | Anchorage

OCT-15-2002 17:00

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10/15/2002 17:36 FAX

003/004

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

In an earlier paragraph of your letter, you imply that the F&J outside review may not be based on F&J's "independent" judgments as to the facts. This suggestion is without foundation. It is my understanding that the F&J investigation, employing more than a dozen attorneys and financial experts, has already encompassed nearly two dozen personal interviews of senior management and key employees, as well as the careful review of several hundred thousand pages of emails and other internal documents.

You imply that this extensive F&J review may not be "outside the control of management." This is not correct. In fact, from the outset Company management committed to the F&J team that it had total independent judgment in the conduct of its review. You and your attorneys can confirm with F&J that that commitment has been and continues to be strictly maintained.

Of course, you have the right to retain your own personal attorneys at your expense. Regarding their access to the F&J current and future work product, I see no problem with that request, subject to appropriate safeguards to protect the privileged nature of the information until such time as the Board elects to make it public. You and all the Board have already heard the full F&J preliminary report read to you during the October 1, 2002, Board meeting. You and other Board members will have access to the final report at the time it is issued to the Board.

2. I am referring your suggestions and questions regarding procedural and Board governance matters to the Company's General Counsel, Mr. William Horton. I also encourage you to raise them with the full Board at its next meeting and with Mr. May, as Chair of the Special Corporate Governance Committee.

Regarding your other points, it is my understanding that the resumes of Mr. Hanson and Mr. May were sent out to all Board members prior to the meetings at which they were elected, and that there were no votes against their election. It is my understanding that you did not raise any of the questions or concerns during those Board meetings regarding their backgrounds or qualifications. You are certainly free to take up these and any other questions raised in your letter with them directly or at the next Board meeting.

Regarding your reference to the need for "good corporate practices" and notice procedures, I would encourage you to propose those to the full Board for discussion and consideration. As you know, at the October 1 Board meeting, Mr. Scrusby took an important initiative on the issue of corporate governance. He nominated Mr. Robert May as Chair and two other Board members to serve on a Special Corporate Governance Committee. Mr. Scrusby's initiative was unanimously endorsed by the Board, yourself included.

I know that your suggestions and concerns on these corporate governance issues are and will be appreciated and welcomed by Mr. Scrusby and Mr. May, as well as the other directors.

3. Please refer to the first two sentences of item 2, above.

**HHEC 408-1412**  
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Requested by HealthSouth Corp.

10/15/2002 17:37 FAX

004/004

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

4. Please refer to the first two sentences of item 2, above. I have passed your request for copies of all previously approved minutes on to Brad Hale.

5. a. I attach a copy of the SEC notice of investigation. There has been no written response on behalf of the Company, although the Company's counsel has been in touch with the SEC to establish a protocol for production of the requested documents.

Regarding making available future correspondence to and from the SEC, you and the other Board members are always welcome to see such correspondence.

b. I have no objection to your reviewing the Patton Boggs engagement letter, but that is a decision I defer to Mr. Horton.

c. I spoke to the SEC officials after receipt of their investigation and they made no verbal comments indicating that the scope of the matters under review by them was any different than the contents of their notice of investigation.

d. I refer to Mr. Horton your request that the CCC be provided with copies of all "information" provided to the SEC as well as any change in the scope of their investigation or any additional issues identified by staff. If such a request were granted to the CCC, it arguably must also be granted to any individual Board member. There are obvious logistical, practical, and possible SEC confidentiality concerns with agreeing ahead of time to such a blanket request.

Regarding your request for updates concerning the investigation, I see no reason why this cannot be done within the constraints of confidentiality consistent with an SEC ongoing investigation - again, with the understanding that there arguably is no basis for distinguishing members of the CCC from other Board members.

e. Mr. Horton will respond to your request concerning the Company's present document retention policy.

I hope this letter has been responsive to yours. I look forward to discussing each of these points with you or your personal attorney - either myself or in conjunction with Mr. Horton.

Sincerely,

  
Lanny J. Davis  
Counsel to HealthSouth Corporation

**HHEC 408-1413**  
Confidential Treatment  
Requested by HealthSouth Corp.

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P. 04

HEALTHSOUTH Corporation  
**MEETING OF THE BOARD OF DIRECTORS**  
 OCTOBER 29, 2002  
 MINUTES

Tab 14

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 29, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrushy, Chairman of the Board of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Larry D. Striplin, Jr., Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, and Lanny J. Davis of Patton Boggs, LLP. With the exception of Mr. Strong, who participated via a telephonic connection whereby everyone could freely hear and speak to one another, all Directors and guests were physically present with Mr. Scrushy in the Board Room.

Richard M. Scrushy acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrushy at 8:00 a.m. C.S.T.

**Executive Session**

The Meeting began in executive session with Messrs. May and Hanson presenting to the Board all documents provided by the law firm of Fulbright & Jaworski, L.L.P. in connection with its investigation of management's knowledge of CMS Transmittal 1753.

The Board reviewed Fulbright & Jaworski's supplemental letter clearing Mr. Scrushy of all allegations of insider knowledge concerning the impact of a Medicare reimbursement rule change

*JD met with  
RS of all knowledge*

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 TREATMENT REQUESTED

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prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 30, 2002.

*As Challenge paper on details as objection - from down to meet with Mr. Hanson & more at meeting*

The Board also agreed to hold a Board Meeting on November 13, 2002, to review final recommendations from Messrs. May and Hanson, if any, regarding members of management's knowledge and understanding of CMS rule changes.

In association with these matters, the Board requested a review to be conducted by a qualified outside party (law professor, retired SEC attorney, etc.) of the Corporation's Legal Services Department, its systems and qualifications of staff, including its Corporate Counsel. Upon conclusion of the review, a summary of findings and recommendations are to be made to the Chairman and the Board of Directors. The Board also directed that the Corporate Counsel should report directly to the Chairman of the Board.

Compensation Committee Action

Mr. Scrusby advised the Board that the approval of the Compensation Committee's recommendation of bonuses to be awarded to the Corporation's executive officers had been omitted from the May 16, 2002 Minutes. Mr. Scrusby asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 Minutes amended to reflect this action.

*This was a ratification of the officer*

After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Striplin, the following resolution was unanimously adopted:

RESOLVED, that the Board of Directors hereby ratifies and confirms, as of May 16, 2002, the bonus recommendations made by the Compensation Committee at the May 16, 2002 Board Meeting and the payment of such bonuses in accordance with such recommendations, and further directs that the minutes of the May 16, 2002 Meeting of the Board of Directors be amended to reflect such approval.

In other Compensation Committee business, Mr. May resigned from the Committee and Mr. Chamberlin was asked to serve as Chairman. After discussion, upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the Board of Directors hereby accepts the resignation of Robert P. May from the Compensation Committee and thanks him for his service thereon.

RESOLVED, that John S. Chamberlin is hereby appointed as Chairman of the Compensation Committee, to serve until the next Annual Meeting of the Board of Directors and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal.

**Compliance Committee Action**

The Board discussed Mr. Gordon's ineligibility to serve on the Compliance Committee because of his status as an employed consultant of the Corporation. As a result, Mr. Gordon resigned from the Committee, and Mr. Scruschy requested that Ms. Givens serve on the Committee in place of Mr. Gordon, and that Dr. Watkins serve as its Chairman. After discussion, upon motion duly made and seconded, the following resolutions were unanimously adopted:

*Mr. Gordon did not resign at the meeting but I would consider request to resign and respond in writing*

RESOLVED, that the Board of Directors hereby accepts Joel C. Gordon's resignation from the Compliance Committee and thanks him for his service thereon.

RESOLVED, that C. Sage Givens is hereby appointed to the Compliance Committee, to serve until the next Annual Meeting of the Board of Directors of this Corporation and until her successor is duly appointed and qualified, or until her earlier death, resignation or removal.

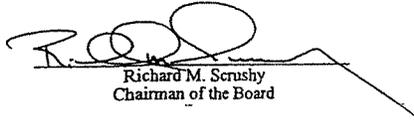
*I proposed accepting resignation not record at the time*

RESOLVED, that Phillip C. Watkins, M.D. is hereby appointed as Chairman of the Compliance Committee, to serve until the next Annual Meeting of the Board of Directors and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal.

**Other Business**

Mr. May distributed to the Board members drafts of charters for the Corporate Governance Committee, Audit Committee, and Compensation Committee, and a draft of an Insider Trading Policy. Mr. May requested that the Board members review each document and return comments to him prior to the next Board Meeting.

There being no further business to transact, the Meeting was adjourned.

  
Richard M. Scrusby  
Chairman of the Board

  
Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

Joel C. Gordon  
6408 East Valley Court  
Nashville, Tennessee 37205

November 1, 2002

Tab 15

Lanny J. Davis  
Patton Boggs LLP  
2550 M Street, N.W.  
Washington, D.C. 20037-1350

Dear Mr. Davis:

I acknowledge receipt of your letter dated October 15. I have delayed responding until I could provide you and the Board as you requested with my proposals for corporate governance changes. I strongly urge careful consideration of these suggestions in order to reflect what I believe to be best boardroom practices.

I understand that my counsel, Harry Weiss at Wilmer, Cutler & Pickering, has discussed the special investigation and the SEC investigation with Hal Hirsch of Fulbright & Jaworski. In that discussion, Mr. Hirsch provided information that I was seeking in my letter to you and offered to provide additional information in the future. In that connection, I look forward to Mr. Weiss being provided access to the Fulbright report presented to the Board this week. As Director and Chair of the Compliance Committee, I believe that my being informed is critical. I regret that you feel that paying for counsel in that connection is an "unnecessary use of corporate resources" and urge that you and the Company reconsider that judgment since all actions were taken by me as a Director and Chair of the Compliance Committee and were done with the intent of acting in the best interests of the Company.

Your letter indicated that you had referred certain of my requests to Mr. Horton and to Mr. Hale. While I have not received any information from them to date, I assume I will do so in the near future and by copy of this letter to them am requesting again that they provide that information to me as soon as possible. The SEC notice of investigation which you indicated was enclosed with your letter was missing and I would appreciate your sending me that document as soon as possible.

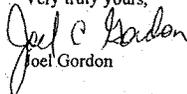
By letter dated October 28, 2002 to Richard Scrushy, your firm raised a question about my service on the Compliance Committee and its consistency with the Compliance Integrity Agreement. I was asked specifically by Mr. Scrushy to serve on and to Chair that Committee and have relied on the Company and its counsel to have been satisfied that there were no issues associated with that service. Needless to say, Mr. Scrushy and the Company's counsel were well aware of my consulting agreement with the Company. Had I known at any time that there was any question about my ability to serve in that role, I would have declined to serve.

**HHEC 355-0100**  
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Requested by HealthSouth Corp.

Notwithstanding the resolution of this issue, I am hereby tendering my resignation as Chairman and member of the Compliance Committee not only in light of the recent question your firm raised but also in light of the limitations imposed on the Compliance Committee with respect to its efforts to address the issues investigated by Fulbright. My concerns have been identified in earlier correspondence with Mr. Scrushy and I will not repeat them here.

I have followed closely your statements to the press about the Company, the investigation and who is or is not responsible for the issues that have faced the Company recently. To the extent that you feel the need to address any issues regarding my service as Chairman of the Compliance Committee, I would expect that the circumstance under which the Compliance Committee was not permitted to act would be accurately and fairly disclosed as well. If this issue is not handled properly, I will consider making my own disclosure.

Very truly yours,

  
Joel Gordon

cc: Richard Scrushy  
Bob May  
Bill Horton ✓  
Brad Hale  
Harry Weiss

**HEALTHSOUTH CORPORATION  
CORPORATE GOVERNANCE POLICIES**

1. Selection of Chairman

The role of the Chief Executive Officer and the Chairman of the Board should be separate and the Chairman should be selected from the non-employee directors. The Chairman shall approve, in consultation with senior management, the agenda for each meeting of the Board.

2. Board Committees

The Board has the following standing committees: Audit, Compensation, Nominating/Corporate Governance and Corporate Compliance. The Board shall adopt and review annually charters for each committee. The Board has the flexibility to form a new committee at any time depending upon the circumstances. All committees shall have the authority to engage, at the expense of the Company, such advisors as they deem necessary or appropriate.

3. Committee Members

The Nominating/Governance Committee, after consultation with the Chief Executive Officer and with consideration of the desires and experience of individual Board members, is responsible for the assignment of Board members to various committees. There is no formal rotation policy.

4. Frequency and Length of Board and Committee Meetings

The Board and its committees meet a number of times during a fiscal year in accordance with a pre-approved schedule of meeting dates. The Chairman of the Board and of each committee has the flexibility to call a special meeting in his or her discretion. The length of each meeting is dependent upon the agenda for the meeting but in general committee meetings are scheduled the afternoon before or the morning of a Board meeting, with the Board meeting considering as part of its agenda reports from each Board committee. Any Board member is free to suggest the inclusion of items on the agenda with appropriate advance notice to the Chairman of the Board and to raise at any Board meeting subjects that are not on the agenda for that meeting. One extended or additional Board meeting each year is to be devoted to reviewing long-term strategic plans and the principal issues facing the Company in the future.

5. Board Agenda and Materials Distributed in Advance

It is the policy of the Board that an agenda describing the nature of business to be conducted at a meeting and all information and data that is important to the Board's and its committees' understanding of the business to be conducted at a meeting be distributed to the Board at least two days before the Board or the committee meets.

6. Executive Session of Non-Employee Directors

It is the policy of the Board for its non-employee directors to meet in executive session as a normal part of the agenda of regular meetings and at such other times as may be determined by any non-employee director.

7. Performance Review of CEO

It is the policy of the Board that the non-employee directors undertake an evaluation of the CEO's performance annually and that it be communicated to the Chief Executive Officer by the Chairman of the Compensation Committee. The evaluation is generally based on objective and subjective criteria, including performance of the business, accomplishment of long term strategic objectives, the development of management and succession planning and other factors as may have been communicated to the Chief Executive Officer. The evaluation is used also by the Compensation Committee in the course of its deliberation when considering the compensation of the Chief Executive Officer.

8. Management Development and Succession Planning

It has been the policy of the Board to discuss succession planning and management development in executive session on a continuous basis. There is expected to be an annual report by the Chief Executive Officer to the Board on succession planning and on the Company's program for management development.

9. Board Access to Senior Management

It is the policy of the Board to have reasonable access to the Company's senior management. It is the policy of the Board to encourage the Chief Executive Officer to from time to time bring managers into Board meetings who can provide additional insight into items being discussed or into significant segments of the Company's business as well as those who represent managers with future potential that senior management believes should be given exposure to the Board. It is the policy of the Board that each member has a responsibility to be informed about all material aspects of the business of the Company, including the qualities of its senior management.

10. Related Party Transactions

All related party transactions between the Company or any of its affiliates and officers and directors or any of his or her affiliates shall be reviewed and approved in advance by the Audit Committee.

11. Composition of the Board

The majority of the Board shall be independent consistent with the requirements of the New York Stock Exchange. The Nominating/Governance Committee is responsible for reviewing and assessing the qualifications of candidates for the Board. This assessment should include issues of independence, diversity, experience and skills, including the

understanding of the various aspects of the Company's business -- all in the context of an assessment of the perceived needs of the Board at that point in time. The Nominating/Governance Committee is responsible for making recommendations in accordance with the bylaws of the Company for new director candidates and the invitation to join the Board should be extended by the Chairman of the Nominating Committee. A director of the Company may not serve on more than three other public company boards of directors.

12. Term and Age Limits

There are no current term age limits for directors. All directors are elected for one year terms and without staggered terms each year all directors must be renominated and elected to serve for another year. While term limits could help ensure that there are fresh ideas and viewpoints available to the Board, they hold a disadvantage of losing the contribution of directors who have been able to develop, over a period of time, insight into the Company and its operations and therefore provide an increasing contribution to the Board as a whole.

13. Board Performance Review

The Nominating/Governance Committee should report annually following the end of each fiscal year an evaluation of the Board's performance. This evaluation should be of the Board's contribution as a whole and specifically review areas in which the Board and/or senior management believes a better contribution could be made. Its purpose is to increase the effectiveness of the Board, not to target individual Board members.

14. Board Compensation Review

It is the policy of the Board that management report annually to the Compensation Committee on the comparability of the Board's compensation policies in relation to other comparable public companies. Changes in Board compensation, if any, should come at the suggestion of the Compensation Committee, but with full discussion and concurrence by the Board. Consideration should be given to including equity compensation as a portion of director compensation.

15. Code of Business Conduct and Ethics

The Corporate Compliance Committee shall review of least annually and approve a code of business conduct and ethics for directors, officers and employees, including policies relating to conflicts of interest, corporate opportunities, fair dealing, confidential "hot lines", and proper use of Company assets. No changes to, or waivers of, such a code may be made without the approval of the committee.

16. Corporate Governance Policies Review

The Nominating/Governance Committee shall review at least annually these policies and shall recommend to the Board any changes it may deem appropriate.

*Send T  
Joel Danko*

Newco Holdings, LLC  
P.O. Box 1116  
2635 Burrland Lane  
Middleburg, Virginia  
20118

Dennis G. Danko  
Managing Partner  
Tel: 540-687-3916  
Fax: 540-687-3111

Tab 16

Date: November 8, 2002

To: Bert Denton.

Subject: HealthSouth

I have received numerous calls from angry HRC shareholders, and to say the least, reaction to the 3<sup>rd</sup> Q results are overwhelmingly negative; one only needs to look at the stock's performance to confirm.

It is clear that Scrusby, Owens, and the HRC management team are in total denial of the facts. Now we hear Management blame the "media and bad press" for the company's problems. Quite the contrary, referrals and business opportunities are being lost because the marketplace is losing confidence in the company and it's management. Owens stated that it is possible that it could take up to a year to "turnaround" the company. That in itself is an admission that matters at HRC are worse than shareholders have been led to believe.

Customers are going to other service providers, employee moral is low, the government has issues with HRC, shareholder lawsuits are mounting, and SHAREHOLDERS HAVE LOST BILLIONS.

Dramatic changes at the Board of Director and senior Management level must be made now; another "reengineering" announcement with associated millions of "one-time charges" is not the answer.

I hope you and your constituents are still committed to the fight against corporate corruption and incompetence, and to effect changes that benefit all shareholders.

*Joel - I REMEMBER YOU AS A TOP NOTCH  
EXECUTIVE FROM MY HOSPITAL DAYS @ HBI IN  
NASHVILLE, AND I DON'T BELIEVE THAT YOU ARE  
TORENT OF SCRUSBY & HIS "BOARD MEMBERS", MAJOR  
CHANGES MUST OCCUR FOR HRC TO MOVE FORWARD  
AND FOR SHAREHOLDERS TO SEE FULL VALUE* *D. Danko*

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Tab 17

**JOEL C. GORDON**

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3102 West End Avenue, Suite 650  
Nashville, TN 37203  
(615) 385-3541  
Fax: (615) 298-5641

**FAX TRANSMISSION COVER SHEET**

---

TO: BRAD HALE  
FROM: JOEL GORDON  
FAX #: (205) 969-4750  
DATE: MARCH 12, 2003  
SUBJECT: BOARD MINUTES

---

**You should receive 2 page(s), including this cover sheet. If you do not receive all the pages, please call Judy Ernst at (615) 385-3541.**

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Brad, I have reviewed the minutes listed on the attached sheet and find no changes. I still am missing August 8, September 17, and November 13. Please forward them to me as soon as possible.

Thanks, Joel

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TREATMENT REQUESTED**

**JG 0000688**

**(H) HEALTHSOUTH.**  
One HEALTHSOUTH Parkway  
Birmingham, AL 35243

MEMORANDUM

TO: Joel C. Gordon

FROM: Brandon O. Hale *BoH*

DATE: March 3, 2003

SUBJECT: Board Minutes

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Enclosed please find Board Minutes for January 31, 2003, February 6, 2003, February 7, 2003, February 14, 2003, and February 21, 2003. Please review and we will discuss and finalize at the Board Meeting in Orlando.

CONFIDENTIAL  
TREATMENT REQUESTED

JG 0000689

HP Fax Series 900  
Plain Paper Fax/Copier

Fax History Report for

Mar 12 2003 3:03pm

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Last Fax

<u>Date</u>	<u>Time</u>	<u>Type</u>	<u>Identification</u>	<u>Duration</u>	<u>Pages</u>	<u>Result</u>
Mar 12	3:02pm	Sent	12059694750	0:42	2	OK

---

Result:  
OK - black and white fax

CONFIDENTIAL  
TREATMENT REQUESTED

JG 0000690

**Unknown**

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**From:** Owens, Bill  
**Sent:** Monday, February 24, 2003 10:41 AM  
**To:** Strong, George  
**Subject:** Thursday Meeting

Tab 18

George,

Richard and I discussed the fact that Joel has always expressed concern about charges in the past. Therefore, we decided to invite him down for the meetings on Thursday, even though he is not on the audit committee. I talked to Joel this morning and he does want to be a part of the meetings. Just wanted to let you know.

Bill

HEALTHSOUTH EIGHT YEAR OPERATING HISTORY

*These Comparisons  
Are not good. How  
Can management receive correct  
Competition.*

	INCOME EXCLUDING EFFECT OF ONE TIME CHARGES AND ASSUMING DILUTION		NET INCOME AFTER ONE TIME CHARGES AND ASSUMING DILUTION		CASH FLOW	NET INCOME % OF REVENUE	WRITE OFF ONE TIME CHARGES		RETURN ON EQUITY	RETURN ON ASSETS	STOCK PRICE HIGH-LOW	
	AMOUNT	PER SHARE	AMOUNT	PER SHARE			AMOUNT	PER SHARE				
995	171,570	0.53	101,096	0.32	0.80	4.5	70,474	0.21	9.5	3.6	16.18	8.18
996	282,577	0.73	196,770	0.55	1.26	0.1	65,779	0.18	16.3	7.0	19.87	13.50
997	354,533	0.92	343,059	0.89	1.59	11.0	11,474	0.03	14.1	7.5	28.93	17.75
998	473,798	1.09	40,558	0.11	0.90	1.2	427,240	0.98	1.4	0.8	30.81	8.68
999	352,029	0.85	76,517	0.18	1.09	1.9	275,512	0.67	2.3	1.1	17.75	4.50
000	278,465	0.71	278,465	0.71	1.84	6.6	-	-	6.3	3.9	17.50	4.75
001	202,000	0.52	202,567	0.51	-1.45*	4.5	123,745	0.31	5.5	2.7	18.40	11.25
002	20,741	0.05	<420,000>	<-1.10>			537,425	1.36			15.90	2.70
003											4.85	3.10

Tab 19

CONFIDENTIAL  
RELATIONSHIP REQUESTED

CONFIDENTIAL  
TREATMENT REQUESTED

**HEALTHSOUTH Corporation**  
**MEETING OF THE BOARD OF DIRECTORS**  
**OCTOBER 15, 2002**

**MINUTES**

Tab 20

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 15, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Charles W. Newhall III, Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, and Lanny J. Davis and Mary Sjoquist of Patton Boggs, LLP. Present with Mr. Scrusby in the Board Room were Messrs. Owens, May, Hale, McVay, Horton and Hervey. All others participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 11:00 a.m. C.D.T.

**Media Relations Update**

Mr. Davis discussed with the Board recent media coverage on Mr. Striplin and his independence as a Director. Mr. Davis stated that the firestorm had died down somewhat in the past

**HHEC 18-02310**

CONFIDENTIAL  
TREATMENT REQUESTED

few days and the Corporation's current strategy was not to talk to the press with stories until we had proactive news to report with a focus on profitability and successes.

#### **Investor Relations Plan**

Messrs. McVay and Hervey reviewed with the Board a written plan developed by the Treasury and Media Relations Departments to enhance investor relations.

#### **Special Litigation Committee Report**

Mr. May presented to the Board a report of activities of the Special Litigation Committee. He reported that the Committee had met twice to date, with one meeting including attorneys from Balch & Bingham, who were retained to represent the Committee. The Committee also met with representatives of Fulbright & Jaworski to assure that all documents are shared with the Committee and Balch & Bingham. Mr. May advised the Board that the Committee had received information on all litigation and would provide the Board with a summary of all cases being reviewed by the Committee.

#### **Corporate Governance Committee Report**

Mr. May reported to the Board that the Committee was in the process of developing a charter for the Corporate Governance Committee, and stated that when the draft was complete he would send a copy to each Board member for his review. Mr. May stated that he anticipated that it would take 90 days to complete all recommendations and that he would have a timeline developed within the next week. In addition to the charter, the Committee is working on an Insider Trading Policy and is reviewing the need to develop a formal Board of Directors Administrative Guideline to include assessment of Directors and executive management.

Mr. May also provided the Board with a status report on outside Committee members being considered to serve on the Corporate Governance Committee.

CONFIDENTIAL  
TREATMENT REQUESTED

**Other Committee Matters**

Mr. Scrushy advised the Board of Mr. Striplin's resignation from the Special Litigation Committee and his resignation as Chairman of the Compensation Committee. Mr. Scrushy then recommended Mr. May be named to serve on the Compensation Committee and to serve as its Chairperson.

After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Gordon, the following resolutions were unanimously adopted:

RESOLVED, that this Board of Directors accepts the resignation of Larry D. Striplin, Jr. from the Special Litigation Committee and his resignation as Chairman of the Compensation Committee of this Board of Directors, commends Mr. Striplin for his service in such roles and looks forward to his continuing service as a member of the Compensation Committee.

RESOLVED, that Robert P. May is hereby appointed to the Compensation Committee as its Chairman, to serve until the next Annual Meeting of the Board of Directors of this Corporation and until his successor is duly appointed and qualified, or until earlier death, resignation or removal.

**Surgery Spin/Split**

Mr. Scrushy recommended to the Board that the Corporation suspend the transaction to spin/split the surgery division, and read a draft press release which outlined the reasons for the suspension of that transaction. After discussion, upon motion duly made by Mr. Gordon and seconded by Dr. Watkins, the following resolution was unanimously adopted:

RESOLVED, that the Board of Directors hereby suspends its previously preliminary approval of the plan for a tax-free separation of the Corporation's surgery center division until further action by the Board of Directors.

Mr. Scrushy advised the Board that the Corporation would continue to assess and present to the Board any legitimate offers for divestiture of surgery facilities.

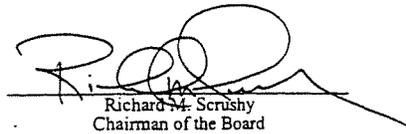
CONFIDENTIAL  
TREATMENT REQUESTED

**Other Business**

Mr. Scrushy updated the Board on meetings to take place with Institutional Shareholder Services on October 16 and with Herbert Denton of Providence Capital in New York on October 17.

Mr. Scrushy advised the Board that the Board retreat scheduled to be held in November in Palm Beach had been cancelled.

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrushy  
Chairman of the Board



Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

Tab 21

BOD 10/24/02

HHEC 293-0253  
Confidential Treatment  
Requested by HealthSouth Corp.

10/23/02

RMS LDS, JC, LM  
PCK, JCB, GSK, JH  
(65)

~~Resolution~~  
~~Resolution~~

Corporate Committee → Re-write process  
approvals

- ① writings
- ② staples

Discussion

\* unanimous approval

Compliance Committee

CIA - Joel Gordon not eligible because he is not independent.

Joel Rizzo as Member of Compliance Committee

— Best out as <sup>Corp</sup> Compliance Officer

Greg Smith stand as Corp Compliance Officer

Corp Governance

\* ① When is resolution on Corporate Governance Committee

Work Assignments  
Call

Bob May

Bob May  
Distributions

Discussion of <sup>Drift</sup> Insider Trading Policy

Drift Charter of Corporate Governance Committee

Drift Charter For Compensation Committee

Modified Audit Committee Charter

Joe Henson

1)

per Bob May call

My hand out Drift of  
Charter For Governance Committee,  
Audit Committee, Compensation Committee  
& Insider Trading Policy and request  
Board members to review & return  
comments to Mr. May prior to the  
next Board meeting

Add to Minutes

① Sage <sup>Graves</sup> replace Ted on Compliance

Phil Withers will chair

Attached minutes

Compliance Committee

Chubb - Chair  
May - ~~OTF~~ Corp

Withers  
Chubb - Chair  
Strop

At

Chairman asked to review legal dept  
- big outside legal firm (contract, admin  
training) to review functions, systems  
qualifications of all to include Gen  
Counsel + make recommendations to  
Chairman + Board

① Board voted for Carol & Huber  
immediately report to Chairman of Corp.

Board spent ~~hours~~ reviewing the  
Marty & Huber report to Board all documents  
provided by F+J on their investigation  
concerning the review the Board asked  
them to perform

Board received F+J supplemental letter  
regarding the clearance of RMS &  
voted to release to press 10/30 the  
results of that letter

Board also agreed to bill another  
party, Nov 13 to receive final  
recommendation from Mr. & Huber if any,  
regarding other on Margaret's report  
to fair understanding & knowledge with  
regard to CML rule changes

Draft

HealthSouth Corporation  
 Meeting of the Board of Directors  
 October 29, 2002  
 Minutes

A Meeting of the Board of Directors of HealthSouth Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 29, 2002, a copy of which is attached to these Minutes.

Board Member Present: RMS, LDS, JSC, RPM,  
 PCW, JCB, CSB, JEM  
 via telephone: GHS

Guest Present: Larry Davis

Richard M. Scorsby acted as Chairman of the Meeting and Brandon O'Hole acted as Secretary.

The Meeting was called to order by Mr. Scorsby at 8:00 AM CST.

Executive Session

The Meeting began in Executive Session with Messrs May and Hanson presenting to the Board all documents provided by Fulbright and Jaworski as a result of the investigation and review. The Board requested them to conduct regarding Messrs. knowledge of CMS Transmittal 1753.

The Board reviewed Fulbright and Jaworski's Supplemental letter regarding the clearing Mr. Sandy of all allegations of insider knowledge concerning the report of a Medicare reimbursement rate change prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 30, 2002.

HHEC 293-0259  
Confidential Treatment  
Requested by HealthSouth Corp.

The Board also agreed to hold another a Board of Directors meeting on November 13, 2002 to review final recommendations from Messrs May and Hanson, if any, regarding other in Management relation to their understanding and knowledge with regard to CMS rule changes.

In association with these matters the Board requesting a review to be conducted

by a qualified outside party (law professor, retired SEC attorney, etc) of the Corporation's legal Department. The review is to include an evaluation of the entire legal Department, its systems and qualifications of staff ~~to~~ include the General Counsel. Upon conclusion of the review recommendations are to be made to the Chairman and the Board of Directors.

In other Compensation Committee meeting, Mr. May missed time, the Committee and Mr. Chubbick had asked to serve as Chairman

Compensation Committee Action

on May 16, 2002

Mr. Scarsy advised the Board that ~~the~~ the Board's approval of the Compensation Committee's recommendations on April 29, 2002 it became to be amended to the Corporation's Executive Officers had been omitted from the May 16, 2002 minutes. Mr. Scarsy asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 minutes amended to reflect this action. A motion was made by Mr. Withers and seconded by Mr. Stoylen and unanimously approved by the Board.

Compliance Committee Action

The Board discussed the fact that Mr. Gordon

was not eligible to serve on the Compliance Committee because he does not meet the test as an independent Director. As a result Mr. Gordon resigned from the Committee and Mr. Somaby requested Ms. Gross serve on the Committee in place of Mr. Gordon and Dr. Vothin serve as Chairman.

#### Other business

Mr. May distributed to Board members drafts of charters for the Corporate Governance Committee, Audit Committee, Compensation Committee and a draft of a Director Trading Policy. Mr. May requested Board members to review each and return comments to him prior to the next Board meeting.

Draft

HealthSouth Corporation  
 Meeting of the Board of Directors  
 October 29, 2002  
 Minutes

A Meeting of the Board of Directors of HealthSouth Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 29, 2002, a copy of which is attached to these Minutes.

Board Members Present: RAS, LBS, JSH, RBA  
 PCW, JCB, GSB, JPH  
 via telephone: GHS

Guest Present: Larry Davis

Richard Mc Sweeney acted as Chairman of the Meeting and Brandon Or Hoke acted as Secretary.

The Meeting was called to order by Mr. Sweeney at 8:00 AM CST.

### Executive Session

The Meeting began in Executive Session with Messrs. May and Hanson presenting to the Board all documents provided by Fulbright and Jaworski as a result of the investigation and review. The Board requested them to conduct - regarding Messrs. Fulbright and Jaworski's knowledge of CMS Transmittal 1753.

The Board reviewed Fulbright and Jaworski's Supplemental letter regarding the clearing Mr. Seidley of all allegations of insider knowledge concerning the impact of a Medicare reimbursement rule change prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 20, 2002.

The Board also agreed to hold another a Board of Directors meeting on November 13, 2002 to review Final recommendations from Messrs. May and Hanson, if any, regarding others in Management relative to their understanding and knowledge with regard to CMS rule changes.

In association with these matters the Board requesting a review to be conducted

Summary of  
Findings

by a qualified outside party (law professor, retired SEC attorney, etc) of the Corporation's legal Department. The review is to include an evaluation of the entire legal Department, its systems and qualifications of staff ~~and~~ include the General Counsel. Upon conclusion of the review recommendations are to be made to the Chairman and the Board of Directors.

In the Compensation Committee, Mr. May advised that the Committee and Mr. Gordon would like to have a chance

Compensation Committee Action

on May 16, 2002

Mr. Secretary advised the Board that ~~the~~ the Board's approval of the Compensation Committee's recommendations on April 29, 2002 of bonuses to be awarded to the Corporation's Executive Officers had been notified from the May 16, 2002 minutes. Mr. Secretary asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 minutes amended to reflect this action. A motion was made by Mr. Watkins and seconded by Mr. Stoyko and unanimously approved by the Board.

Compensation Committee Action

The Board discussed the fact that Mr. Gordon

was not eligible to serve on the Compliance Committee because he does not meet the test as an independent Director. As a result Mr. Gordon resigned from the Committee and Mr. Scandhy requested Ms. Green serve on the Committee in place of Mr. Gordon and Dr. Watkins serve as Chairman.

Other business

Mr. May distributed to Board members drafts of charters for the Corporate Governance Committee, Audit Committee, Compensation Committee and a draft of an Insider Trading Policy. Mr. May requested Board members to review each and return comments to him prior to the next Board meeting.

Tab 22

**Melendez, Madelene**

**From:** Davis, Lanny  
**Sent:** Wednesday, October 30, 2002 8:50 AM  
**To:** 'hanson@usstrategies.com'  
**Subject:** Fw: CORRECTED Draft press releases--alternative versions ATTORN EY-CLIENT  
 PRIVILEGED AND CONFIDENTIAL

**Importance:** High

I don't understand this message. Call me.

-----Original Message-----

**From:** Scrusby, Richard <rscrusby@healthsouth.com>  
**To:** 'LDavis@PattonBoggs.com' <LDavis@PattonBoggs.com>  
**Sent:** Wed Oct 30 08:04:56 2002  
**Subject:** Re: CORRECTED Draft press releases--alternative versions ATTORN EY-CLIENT PRIVILEGED  
 AND CONFIDENTIAL

I don't believe we should do anything that puts us in a negative position or could cost us in the litigation. I need my name cleared as well. Horton and your being pissed off at him should play no role in our judgement or decisions. Sending the total report to the S.E.C. May not be the right thing because fbj put things in the report that are wrong. If the report was fair and accurate I would feel better about giving them the full report. I prefer to answer all questions and give them all the information they request as they request. I just believe we can get the newspaper to write the story and you can position it as an obligation since they killed me on no facts. If fbj will not help us on this then they are done one this project. Pls let's just get me cleared and not create any more distractions that make it harder on me to get back to running the company. I have enough BS to deal with now to include the new independence exhibited in the bod meeting yesterday which was really ego driven and had nothing to do with knowledge and much of it was wrong but I didn't have any warning. So great to have new friends huh? So let's just get the press done today please. Thankyou richard

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

Confidentiality Notice: This e-mail communication and any attachments may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

PB 01863

Melendez, Madelene

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From: Davis, Lanny  
Sent: Tuesday, October 29, 2002 10:44 PM  
To: 'rscrushy@healthsouth.com'  
Cc: 'jason.hervey@healthsouth.com'; 'ehanson@usstrategies.com'  
Subject: Re: CORRECTED Draft press releases--alternative versions ATTORNEY-CLIENT  
PRIVILEGED AND CONFIDENTIAL

Importance: High

Spoke to Hal. He will agree to have FandJ person confirm quote is accurate. Without the quote and confirmation, we run a great risk that the story will be downplayed and/or not run at all. We need a decision first thing in am so we can begin briefing NYTs and WSJ and Bloomberg, Reuters, and wires as well as Birmingham News. It is my strong recommendation that this is the best course for clearing your name and helping the Company. Moreover I hope you agree that we should assert no legal privileges in turning over the report regarding you to the S.E.C. The cost of backtracking on our commitment to the press and the S.E.C. is not justified, especially since the S.E.C. will agree to a confidentiality agreement. Let's talk first thing in am.

**Goldberg, Adam**

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**From:** deborah.smith@fticonsulting.com **Tab 22**  
**Sent:** Tuesday, November 12, 2002 3:01 PM  
**To:** LDavis@pattonboggs.com  
**Cc:** Goldberg, Adam; Dominic.dinapoli@fticonsulting.com; Sjoquist, Mary  
**Subject:** Re: Fw: HealthSouth

Lanny, Adam and Mary,

As requested, attached please find our estimated fees to complete.

Regards,

Debbie Smith

---

Deborah M. Smith  
Senior Managing Director  
FTI Consulting, Inc.  
1177 Avenue of the Americas  
New York, New York 10036  
646-471-2313  
deborah.smith@fticonsulting.com

PB 02379

9/15/2003



**Fee Estimate for Remaining Tasks**

<u>Task</u>	<u>Estimated Fees and Expenses</u>
Unbilled actual time from November 6, 2002 through November 12, 2002.	\$ 24,756
Presentation of the FTI report by Dom DiNapoli, Debbie Smith and Martin Cohen to the Board of Directors.	18,000
Review of the FTI report by Debbie Smith and Martin Cohen with management and minor edits to the report to incorporate management's comments and feedback.	19,000
Companson of the Company's actual third-quarter outpatient therapy results with last year and with FTI's findings: Reconciliation of outpatient therapy net revenue, including changes in contractual allowances and other reserves; Comparison of 3Q2002 coding / billing patterns with 3Q2001; Comparison of 3Q2002 coding / billing patterns with FTI's re-coded sample data; 3Q2002 monthly coding / billing analysis.	42,000
Analysis of the Company's reported outpatient therapy referral and visit volume trends: Analyze change in referral (admission) volume between 3Q2002 and 3Q2001; Analyze change in visits per discharge between 3Q2002 and 3Q2001; Analyze change visits per therapist FTE between 3Q2002 and 3Q2001.	13,000
<b>Total Remaining Fees and Expenses</b>	<b>\$ 116,756</b>

# Memorandum

To: Brad Hale, Bill Horton

CC: Governance Committee

From: Bob May *Bob Jack*

Tab 24

Date: 3/12/03

Re: Minutes

---

After reviewing what I believe are the latest complete sets of minutes I now have my suggested corrections/edits:

1. October 1, 2002 minutes incorrectly reports Larry Stripin resigning from Litigation Committee. That event is reported correctly in the October 15, 2002 minutes, the October 1, 2002 minutes need to be corrected
2. October 22, 2002 minutes still missing. I understand these are being reviewed by Fulbright & Jaworski.
3. October 29, 2002 minutes under executive session first item-- should be expanded to read that in addition to presenting the F&J documents, Jon and I made preliminary recommendations concerning actions taken/not taken surrounding transmittal 1753, after reviewing the F&J documents and interviewing key members of management.
4. January 6, 2003 minutes should reflect an additional bullet item under the TCV/Source Medical. Bullet point number four should be added to reflect the Boards instruction to search for additional partner/venture firms who could purchase Source under more favorable conditions.
5. February 6, 2003—Jon Hanson reports that he was on the telephone board call.

1

CONFIDENTIAL  
TREATMENT REQUESTED

JC 0001227

# Memorandum

---

To: George Strong  
CC: Governance Committee  
From: Bob May  
Date: 6/11/2003  
Re: 10 K Signature(s) 2003

Tab 25

George in reviewing the latest package of minutes sent out by Brad Hale, I read with interest the statements from Mr. Lamphron of E & Y from the March 15, 2002 minutes. I will not attempt to duplicate the minutes but simply paraphrase the comfort he gave the board, by stating that there were no Enron type issues or exposures. E&Y "focused heavily" on those types of items when evaluating our books.

Mr. Lamphron, gave the Board similar if not stronger assurances during our most recent meeting in Orlando, where the Board signed this years 10k. Many of us relied on the Audit Committee and Mr. Lamphron assurance when signing this document.

HEALTHSOUTH may not have "Enron" type issues. However, we did have some unusual charge offs relating to prior years/periods (in particular bad debt) that we were informed of at the 11<sup>th</sup> hour before our 4<sup>th</sup> Quarter earnings release.

My issue is simply this. What assurances can we have from E & Y that next year we will not have the same issues? Obviously, if we do the consequences would be disastrous.

I leave this question in your hands to handle as you deem appropriate.

CONFIDENTIAL  
TREATMENT REQUESTED

RM 0000388

06/16/2003 11:12 FAX

DC 12TH FLR FAX

004

[Click here and type address]

Tab 26



To: Jon Hanson Fax: 205 261 2527

From: Bob May Date: 6/11/2003

Re: BOD Recommendations Pages: [Click here and type number of pages]

CC: [Click here and type name]

Urgent  For Review  Please Comment  Please Reply  Please Recycle

Other issues presented to the Board were:



- Business process management
- Complexity and confusion of CMS transmittal
- Communication issues (lack thereof)
- Organization design
- Sense of ownership of CMS issue
- Support systems level of maturity
- Decision making process
- Controls
- Role of Finance organization in CMS issue
- Sense of urgency
- Policy area of the company- personnel, reporting position & process.

These were the major items presented. Let me know whether we want to include any or all of these items in Board minutes.

PRELIMINARY REVIEW  
HIGH LEVEL ISSUES

PROCESS MANAGEMENT  
VOID

COMMUNICATION

ORGANIZATION DESIGN

SENSE OF OWNERSHIP

STAFF / SUPPORT SYSTEMS

DECISION MAKING

CONTROLS

FINANCE ROLE

SENSE OF URGENCY

"POLICY" POSITION + PROCESS

**HEALTHSOUTH Rehabilitation Corporation****Meeting of the Board of Directors****August 5-7, 1994****MINUTES****Tab 27**

A Meeting of the Board of Directors of HEALTHSOUTH Rehabilitation Corporation (the "Corporation") was held on August 5-7, 1994 at the Perdido Beach Resort, Orange Beach, Alabama, pursuant to a Waiver of Notice dated August 5, 1994, a copy of which is attached to these Minutes.

The following Directors, constituting the entire Board of Directors, were present in person at the meeting: Richard M. Scrusby, Chairman of the Board, President and Chief Executive Officer of the Corporation, C. Sage Givens, Charles W. Newhall III, Richard F. Celeste, John S. Chamberlin, George H. Strong, Phillip C. Watkins, M.D., Larry R. House, James P. Bennett, President- HEALTHSOUTH Inpatient Operations, Aaron Beam, Jr., Executive Vice President and Chief Financial Officer and Anthony J. Tanner, Executive Vice President and Secretary.

The following guests were also present at the meeting: Russell H. Maddox, President, Diagnostic Health Corporation, Thomas W. Carman, Executive Vice President - Corporate Development of the Corporation, Denis J. Devane, Executive Vice President - Medical Center Operations of the Corporation, P. Daryl Brown, President - HEALTHSOUTH Outpatient Centers of the Corporation, Michael D. Martin, Senior Vice President and Treasurer of the Corporation, Eric R. Hanson of U.S. Strategies, Inc., and Benjamin D. Lorello, William C. McGahan and John K. Hudson of Smith Barney Inc.

Richard M. Scrusby acted as Chairman of the Meeting and Anthony J. Tanner acted as Secretary.

**HealthSouth 00701****HHEC 427-0308**  
Confidential Treatment  
Requested by HealthSouth Corp.

RESOLVED, that the President - HEALTHSOUTH Outpatient Centers, a division of this Corporation, and the other appropriate officers which constitute the management of the division, are hereby authorized to carry out and consummate any outpatient development project for this Corporation without specific prior authorization of this Board of Directors, provided that the total cost of such development project shall not be more than one-half of one percent of the Corporation's total assets, the "red file" procedure established by the Outpatient Division of this Corporation is strictly followed and this Board of Directors is given the opportunity to ratify such acquisitions as are so consummated at each of its regular meetings.

RESOLVED, that the proper offices of this Corporation or of any subsidiary of this Corporation are hereby authorized to certify such resolutions as shall be approved by counsel to this Corporation (whether internal or external counsel) as having been adopted by this Board of Directors or the Board of Directors of any such subsidiary in connection with the consummation of any outpatient development project carried out pursuant to the authority granted in the foregoing resolution, their authority to do so to be conclusively evidenced thereby.

RESOLVED, that the actions of the management of the Outpatient Division in carrying out and consummating the outpatient development projects set forth on the list presented to this meeting and attached to the Minutes of this meeting as Exhibit A are hereby ratified and approved as and for the actions of this Corporation.

In conjunction with the above action, the Board discussed the need to remove the restriction of a specific numerical dollar value on Mr. Scrusby's level of authority. Upon action made by Dr. Watkins and seconded by Mr. Strong, the following resolution was animously adopted:

RESOLVED, that the Chairman of the Board, President and Chief Executive Office of this Corporation is authorized to commit, in any single transaction or group of related transactions, up to one percent of the total assets of the Corporation pursuant to such agreements, documents or instruments as he, after any appropriate consultation with counsel and other officers of this Corporation, deems appropriate.

SCHEDULE 14A INFORMATION

PROXY STATEMENT PURSUANT TO SECTION 14(A)  
OF THE SECURITIES EXCHANGE ACT OF 1934

Filed by the Registrant

Filed by a Party other than the Registrant

Tab 28

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for use of the Commission only (as permitted by Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to Rule 14a-11(c) or Rule 14a-12

HEALTHSOUTH CORPORATION

-----  
(NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

-----  
(NAME OF PERSON(S) FILING PROXY STATEMENT)

Payment of Filing Fee (Check appropriate box):

- No fee required.
  - Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.
- (1) Title of each class of securities to which transaction applies:-----
  - (2) Aggregate number of securities to which transaction applies:-----
  - (3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11: (Set forth the amount on which the filing fee is calculated and state how it was determined.)-----
  - (4) Proposed maximum aggregate value of transaction:-----
  - (5) Total fee paid:-----
- Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.
- (1) Amount previously paid:-----
  - (2) Form, Schedule or Registration Statement No.:-----
  - (3) Filing Party:-----
  - (4) Date Filed:-----

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HEALTHSOUTH CORPORATION  
NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

April 17, 1998

The Annual Meeting of Stockholders of HEALTHSOUTH Corporation (the "Company") will be held at One HealthSouth Parkway, Birmingham, Alabama, on Thursday, May 21, 1998, at 2:00 p.m., C.D.T., for the following purposes:

1. To elect twelve Directors to serve until the next Annual Meeting of Stockholders and until their successors are duly elected and qualified.
2. To vote upon an Amendment to the Restated Certificate of Incorporation of the Company to increase the authorized Common Stock of the Company to 600,000,000 shares of Common Stock, par value \$.01 per share.
3. To approve the 1998 Restricted Stock Plan of the Company.
4. To vote upon a proposal submitted by Iron Workers' Local No. 25 Fringe Benefit Funds urging the Board of Directors to establish certain additional requirements for service on the Compensation Committee.
5. To transact such other business as may properly come before the Annual Meeting or any adjournment thereof.

Stockholders of record at the close of business on March 30, 1998, are entitled to notice of, and to vote at, the Annual Meeting or any adjournment thereof.

IF YOU CANNOT ATTEND THE ANNUAL MEETING IN PERSON, PLEASE DATE AND EXECUTE THE ACCOMPANYING PROXY AND RETURN IT PROMPTLY TO THE COMPANY. IF YOU ATTEND THE ANNUAL MEETING, YOU MAY REVOKE YOUR PROXY AND VOTE IN PERSON IF YOU DESIRE TO DO SO, BUT ATTENDANCE AT THE ANNUAL MEETING DOES NOT OF ITSELF SERVE TO REVOKE YOUR PROXY.

ANTHONY J. TANNER

Secretary

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HEALTHSOUTH CORPORATION  
PROXY STATEMENT

INTRODUCTION

This Proxy Statement is furnished to the holders of Common Stock, par value \$.01 per share, of HEALTHSOUTH Corporation (the "Company") in connection with the solicitation of Proxies by and on behalf of the Board of Directors of the Company for use at the Annual Meeting of Stockholders to be held on May 21, 1998 or any adjournment thereof. A form of Proxy for use at the Annual Meeting is also enclosed. Any such Proxy may be revoked by a stockholder at any time before

No awards have been made under the 1998 Restricted Stock Plan. The number of shares covered by particular awards to be made under the 1998 Restricted Stock Plan is not determinable at this time.

VOTE REQUIRED; RECOMMENDATION OF THE BOARD OF DIRECTORS

Management recommends a vote FOR the adoption of the 1998 Restricted Stock Plan. The affirmative vote of the holders of a majority of the outstanding shares of the Common Stock present or represented and entitled to vote at the Annual Meeting will be necessary for stockholder approval of the 1998 Restricted Stock Plan.

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STOCKHOLDER PROPOSAL

THE IRON WORKERS' PROPOSAL

Iron Workers' Local No. 25 Fringe Benefit Funds, 25130 Trans X Drive, Novi, Michigan 48375-2438, claiming beneficial ownership of "over 20,000 shares" of the Company's Common Stock through Iron Workers' Local No. 25 Pension Fund, has submitted the proposal set forth below (the "Iron Workers' Proposal", as defined above).

"SHAREHOLDER PROPOSAL

"The shareholders urge that the Board of Directors adopt a policy that no board member shall serve on the Compensation Committee if he or she is not an independent director. For these purposes, the Board shall adopt the following definition of independence -- based on a definition adopted by the Council of Institutional Investors -- to mean a director who:

1. has not been employed by the Company or an affiliate in an executive capacity;
2. has not been a member of a corporation or firm that is one of the Company's paid advisors or consultants;
3. has not been employed by a significant customer or supplier to the Company;
4. has not had personal services contract with the Company or its affiliates;
5. has not been employed by a foundation or university that receives grants or endowments from the Company;
6. is not a relative of an executive of the corporation or its affiliates;
7. has not been part of an interlocking directorate in which the CEO or other executive officer of the Company serves on the board of another corporation that employs the director;
8. and has not had any personal, financial and/or professional relationships with the CEO, other executive officers, or the Company that would interfere with the exercise of independent judgment by such director.

"SUPPORTING STATEMENT

"The purpose of this proposal is to incorporate within the Audit and Compensation Committee a standard of independence that will permit objective decision making on compensation issues at HEALTHSOUTH. While HEALTHSOUTH does require that directors meet a minimal standard of independence to serve on the committee, this standard is not sufficient to ensure that a director is free of relationships that could diminish his or her independent judgment. Currently, there are two directors on the Committee with conflict of interest issues.

"According to real estate assessment records in Monroe County, Florida, Dr. Phillip Watkins and CEO Richard Scrushy jointly own property in Key Colony Beach, a resort area in the Florida Keys. The property was purchased in June 1994 by Dr. Watkins and Mr. Scrushy for approximately \$400,000. Dr. Watkins also owns a yacht registered in Key Colony Beach.

"HEALTHSOUTH has arranged a credit agreement with Nationsbank allowing the company to invest up to \$5 Million in Acacia Venture Partners, a private venture capital fund. C. Sage Givens is a founder and the managing general partner of Acacia Venture Partners.

"Additionally, Givens' firm recently invested \$4 Million in Managed Care USA, a company specializing in managing worker's compensation claims. As reported in the Charlotte Business Journal, Ms. Givens helped to secure a national contract between Managed Care USA and HEALTHSOUTH through her position on the Board.

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"Shareholders are best served if Committee members are truly independent. This is especially important considering the large compensation packages awarded to executive officers of HEALTHSOUTH. Richard Scrushy, earning over \$22 Million in 1996, is among the top overpaid CEO's in the nation according to Graef Crystal, a leading executive compensation expert."

## RESPONSE OF THE BOARD OF DIRECTORS

The Board of Directors recommends a vote AGAINST the Iron Worker's Proposal, for the reasons set forth below.

The Company's Board of Directors agrees that decisions concerning the compensation of executive officers should be made by a committee of independent directors. The Board believes that each of the members of the Audit and Compensation Committee is, in fact, independent, and a valuable member of the Committee. The Board further believes that the arbitrary standard suggested by the proposal is unworkable when applied to a large, national business such as that of the Company and would in fact deprive the Committee of expert independent judgment and substantial institutional knowledge of the Company and its business.

The current members of the Committee have all been directors of the Company since prior to its initial public offering in 1986, and (with the exception of Ms. Givens, who was named to the Committee in 1989) have served on the Committee for more than 10 years. Each member of the Committee meets the definition of independence adopted by the New York Stock Exchange, which excludes any director who has "any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment. Further, each member meets the more stringent test of being an "outside director" under the regulations promulgated under Section 162(m) of the Internal Revenue Code of 1986, as

amended (which regulations provide, among other things, that an outside director cannot be a current employee, a former employee receiving compensation for prior services (subject to certain exceptions), a current or former officer of the corporation, or a person who receives (or is entitled to receive) remuneration from the corporation in any capacity other than as a director).

The Board of Directors believes that the arbitrary requirements proposed under the Iron Workers' Proposal are unnecessary and inappropriate in that, unlike the standards imposed by the New York Stock Exchange and the Internal Revenue Code, such requirements would, for example, presume that a director was not independent because that director was an employee of a company that engaged in arm's-length commercial transactions with the Company in the ordinary course of business, or of a foundation or university that received grants or endowments from the Company. The Company operates in all 50 states, the United Kingdom and Australia, and as a consequence has customer or supplier relationships with a wide range of other companies around the world which may or may not meet the undefined and subjective standard of being "significant." Likewise, as part of its policy of corporate stewardship, the Company provides support to a number of charitable foundations and educational institutions around the country. The arbitrary requirements contained in the Iron Workers' Proposal would, without further inquiry into the substantive independence of the directors, automatically bar any employees of such companies, foundations and institutions from serving on the Committee, potentially depriving the Committee of knowledgeable and experienced insight into the matters facing it.

With respect to the current members of the Committee, the Board of Directors takes strong issue with the suggestion that any of them lack independence. The Board certainly does not believe that the former joint ownership of vacation property by Dr. Watkins and Mr. Scrusby (which joint ownership was terminated in 1997) has in any way influenced Dr. Watkins's judgment, nor does the Board understand the significance of the statement concerning Dr. Watkins's yacht. The Company, along with numerous pension funds, university endowments and other institutional investors, has made an investment in Acacia Venture Partners, and such investment is one of many permitted under the Company's principal credit agreement. Such investment is not material to the Company. In addition, the Board does not understand why the proponents apparently find it troublesome that Ms. Givens has utilized her role to assist the Company in obtaining a potentially valuable managed care contract for the Company.

The Board of Directors believes that the existing standards for independence of the Audit and Compensation Committee are consistent with industry standards and with the best interests of the Company's stockholders, and that the requirements set forth in the Iron Workers' Proposal would

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impose arbitrary and unnecessary limitations that could deprive the Company and its stockholders of valuable present and future members of the Committee. The Board further notes that the existing members of the Committee bring a wealth of knowledge about the Company and the healthcare industry to bear on the Committee's decisions, and that the compensation plans developed and implemented by the Committee have enabled the Company to attract and retain a management team that has led the Company to become the only healthcare services provider to operate facilities in all 50 states, to a record of 46 consecutive quarters of meeting or exceeding analysts' expectations, to become part of the S&P 500 only 13 years from inception, and to become the nation's largest provider of outpatient surgery and rehabilitative healthcare services. The Board believes that its existing policies with respect to the Audit and Compensation Committee

have served the Company and its stockholders well, and that the Iron Workers' Proposal is unnecessary and inadvisable.

VOTE REQUIRED; RECOMMENDATION OF THE BOARD OF DIRECTORS

The Board of Directors recommends a vote AGAINST the Iron Workers' Proposal. The affirmative vote of the holders of a majority of the outstanding shares of the Common Stock present or represented and entitled to vote at the Annual Meeting will be necessary for stockholder approval of the Iron Workers' Proposal.

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EXECUTIVE COMPENSATION AND OTHER INFORMATION

EXECUTIVE COMPENSATION -- GENERAL

The following table sets forth compensation paid or awarded to the Chief Executive Officer and each of the other four most highly compensated executive officers of the Company (the "Named Executive Officers") for all services rendered to the Company and its subsidiaries in 1995, 1996 and 1997.

SUMMARY COMPENSATION TABLE

<TABLE>  
<CAPTION>

NAME AND PRINCIPAL POSITION	YEAR	ANNUAL COMPENSATION		LONG-TE
		SALARY	BONUS/ANNUAL INCENTIVE AWARD	STOCK OPTIO AWARD
<S>	<C>	<C>	<C>	<C>
Richard M. Scrushy	1995	\$1,748,646	\$ 5,000,000	2,000,0
Chairman of the Board	1996	3,391,775	8,000,000	1,500,0
and Chief Executive Officer(3)	1997	3,398,999	10,000,000	1,300,0
James P. Bennett	1995	382,528	600,000	300,0
President and Chief	1996	496,590	800,000	200,0
Operating Officer	1997	639,161	1,500,000	700,0
Michael D. Martin	1995	176,746	500,000	170,0
Executive Vice President,	1996	281,644	750,000	120,0
Chief Financial Officer	1997	359,672	2,000,000	450,0
and Treasurer				
P. Daryl Brown	1995	274,582	310,000	260,0
President -- HEALTHSOUTH	1996	335,825	400,000	100,0

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HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS

AUGUST 10, 2000

MINUTES

Tab 29

A Meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated August 10, 2000, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, Phillip C. Watkins, M.D., George H. Strong, John S. Chamberlin, Charles W. Newhall III, C. Sage Givens, Joel C. Gordon, Larry D. Striplin, Jr. and Jan L. Jones. The following guests were also present: Thomas W. Carman, Executive Vice President – Corporate Development of the Corporation, William T. Owens, Executive Vice President and Chief Financial Officer of the Corporation, Patrick A. Foster, President and Chief Operating Officer – Ambulatory Services – West of the Corporation, Robert E. Thomson, President and Chief Operating Officer – Inpatient Operations of the Corporation, Weston L. Smith, Senior Vice President – Finance and Controller of the Corporation, Brandon O. Hale, Senior Vice President – Administration and Secretary of the Corporation, Malcolm E. McVay, Senior Vice President – Finance and Treasurer of the Corporation, and Larry D. Taylor, Senior Vice President – Ambulatory Services – East of the Corporation, and P. Daryl Brown.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 11:00 a.m. C.D.T.

Mr. Scrusby opened the meeting by showing the Board a videotape of the second quarter 2000 State of the Company Address which was videotaped at the groundbreaking of the Colorado Springs, Colorado Integrated Medical Plaza.

HHEC 18-02152

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#### Financial Review

Mr. Owens led the Board through a review of the Corporation's financial performance in the second quarter of the year. In his presentation Mr. Owens highlighted key balance sheet items and quarter-to-quarter trends of patient volume and revenue by product line. There was general discussion regarding second quarter results and the Corporation's efforts to reduce days' sales outstanding.

#### Operations Review

Inpatient Operations. Mr. Thomson led the Board through a review of the inpatient division. Mr. Thomson discussed organizational structure, critical factors for volume growth and continuing efforts toward expense reduction. Also discussed were key factors which impact the inpatient division's efforts to improve collections.

Ambulatory Services – West. Mr. Foster led the Board through a review of the Ambulatory Services – West division. Mr. Foster highlighted improvements in volume and margin for the Division and discussed current growth opportunities.

Ambulatory Services – East. Mr. Taylor led the Board through a review of the Ambulatory Services – East division. Mr. Taylor discussed performance of the division by product line and outlined strategy for growth within the division.

#### Development Review

Mr. Carman led a review of corporate development activities, showing that the Corporation had completed 110 projects during the first six months of the year. There was general discussion about pending projects and prospects for the future.

#### Chairman's Review

Mr. Scrushy presented to the Board an overview of initiatives under development with potential strategic partners to take advantage of the HEALTHSOUTH franchise. Mr. Scrushy also

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discussed strategies for increasing volume and reducing of costs and updated the Board on healthsouth.com. There was general discussion about these initiatives and their impact on the Corporation.

**HCAP Update**

At this time Mr. Brown was invited into the Board Room to provide the Board with an update on the development of the HCAP project. Mr. Brown highlighted the key features and benefits of the HCAP wireless product and discussed the many reasons why electronic medical records are a high priority with healthcare providers.

**Treasury Update**

Mr. McVay provided the Board with an update on treasury issues, including an overview of second quarter results and recent stock performance. Mr. McVay also outlined financing opportunities currently being considered.

**Other Business**

All guests, with the exception of Messrs. Owens and Hale, exited the Board Room. Mr. Scrusby then led the Board in a general discussion of recent management changes as a result of Mr. Bennett's resignation and the Corporation's succession plan. There was general discussion and comment regarding these changes and the succession plan being developed.

**Promotions**

Mr. Scrusby recommended the following individuals for promotion in recognition of their continuing contributions and responsibilities. Upon motion duly made by Mr. Newhall, with second by Mr. Watkins, the following resolution was unanimously adopted:

RESOLVED, that the following persons are hereby appointed to the offices set forth following their names below, each to serve until the next Annual Meeting

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of the Board of Directors of this Corporation and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal:

Larry D. Taylor	President and Chief Operating Officer – HealthSouth Ambulatory Services – East
M. Sean Huffman	Group Vice President – Operations

Dr. Watkins indicated that the Audit and Compensation Committee take appropriate action regarding stock option grants for the promoted individuals.

**Audit Committee Charter**

Mr. Strong and Mr. Owens presented the proposed Audit Committee Charter for approval by the Board of Directors. Mr. Owens indicated that the Audit Committee Charter had been developed by the Corporation in consultation with Ernst & Young, LLP and that it complied with the requirements imposed by the Securities and Exchange Commission and the New York Stock Exchange. After discussion, upon motion duly made and seconded, the following resolution was unanimously adopted:

RESOLVED, that the Audit Committee charter attached to these minutes as Exhibit A is hereby adopted as the Audit Committee Charter of this Corporation, to be reviewed and reassessed by the Audit Committee of the Board of Directors at least annually.

**Compliance Report**

Mr. Hale reported that the corporate compliance hotline had received 465 cases year-to-date, with the majority dealing with human resources issues. Mr. Hale also reported that the Corporate Compliance Department continues to monitor all compliance training and is currently working to integrate compliance training into the HEALTHSOUTH intranet.

**Proposed Bond Financing**

Messrs. Scrusby and Owens presented a description of the proposed subordinated debt financing being explored by the Corporation. Mr. Owens indicated that the financing would be used

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to redeem the Corporation's outstanding 9.5% Senior Subordinated Notes due 2001 and for other corporate purposes. After discussion, upon motion duly made and seconded, the following resolution were unanimously adopted:

RESOLVED, that this Corporation create an issue of eight-year senior subordinated notes to be called the \_\_\_\_\_% Senior Subordinated Notes due 2008 (the "Securities") in an aggregate principal amount not exceeding \$350,000,000 to be issued pursuant to an indenture, in substantially the form presented to this Meeting, to be dated such date as the officers executing the same shall determine, between this Corporation and The Bank of New York, the trustee named therein (the "Indenture"), to bear interest at annual rates to be fixed as hereinafter provided, said interest to be payable as set forth in the Indenture and in the Securities, and to contain such covenants and other terms and conditions as are set forth in the Indenture, that the Securities be sold to UBS Warburg LLC and/or a group of initial purchasers to be formed by it (the "Initial Purchasers"), severally, pursuant to a Purchase Agreement, at the public offering price less an initial purchasers' discount and plus accrued interest, if any, from the date of issuance of the Securities, and that the principal amount of Securities (not exceeding \$350,000,000), the rate of interest, redemption price, public offering price, initial purchasers' discount, maturity date (which shall not be less than four years or greater than ten years), covenants and other terms and conditions be as determined by the Pricing Committee appointed by the Board of Directors of this Corporation, consisting of Richard M. Scrushy and William T. Owens, by a writing signed by at least one of such persons.

RESOLVED, that the Chairman of the Board, the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President and the Treasurer of this Corporation, and each of them, acting severally, are hereby authorized to execute and deliver on behalf of this Corporation to UBS Warburg LLC, acting on behalf of the Initial Purchasers named therein, a Purchase Agreement relating to the purchase of the Securities by such Initial Purchasers, such Purchase Agreement to be substantially in the form presented to this Meeting, but with such changes as the person executing such Purchase Agreement shall approve, such approval to be evidenced by such execution.

RESOLVED, that the Chairman of the Board, the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President and the Treasurer of this Corporation, and each of them, acting severally, are hereby authorized to execute and deliver on behalf of this Corporation to UBS Warburg LLC, acting on behalf of the Initial Purchasers named in the aforesaid Purchase Agreement, a Registration Rights Agreement relating to the purchase of the Securities by such Initial Purchasers, such Registration Rights Agreement to be substantially in the form presented to this Meeting, but with such changes as the person executing such Registration Rights Agreement shall approve, such approval to be evidenced by such execution.

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RESOLVED, that the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Treasurer, the Secretary or any Assistant Treasurer or Assistant Secretary of this Corporation, and each of them, acting severally, are hereby authorized and directed to prepare, execute, acknowledge, verify, deliver, publish and circulate in the name and on behalf of this Corporation a Preliminary Offering Memorandum and an Offering Memorandum with respect to the Securities for use by the Initial Purchasers in connection with exempt resales of the Securities.

RESOLVED, that, in the event that facsimile signatures of any of the following officers are at any time to be affixed on the Securities, the facsimile signatures of Richard M. Scrusby as Chairman of the Board and Chief Executive Officer of this Corporation, William T. Owens as Executive Vice President and Chief Financial Officer of this Corporation, Malcolm E. McVay as Senior Vice President and Treasurer of this Corporation, William W. Horton as Senior Vice President, Corporate Counsel and Assistant Secretary of this Corporation, and Brandon O. Hale as Secretary of this Corporation, are adopted, ratified and confirmed as the facsimile signatures of such officers to be affixed on the Securities in the name of and on behalf of this Corporation.

RESOLVED, that in case any authorized officer of this Corporation who shall manually or in facsimile sign or seal any of the Securities ceases to be such officer of this Corporation before the Securities so signed and sealed have actually been authorized or delivered, the Securities nevertheless may be authenticated, issued and delivered with the same force and effect as though such person had not ceased to be such officer of this Corporation; and that the Securities may be signed and sealed on behalf of this Corporation by such person who, on the actual date of the execution of such Securities, is a proper officer of this Corporation although on the nominal date of such Securities, such person is not such officer of this Corporation.

RESOLVED, that the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Treasurer, the Secretary or any Assistant Treasurer or Assistant Secretary of this Corporation are hereby authorized to execute and deliver the Indenture between this Corporation and The Bank of New York in substantially the form presented to this Meeting, but with such changes as the person executing such Indenture shall approve, such approval to be evidenced by such execution.

RESOLVED, that when the Indenture shall have been duly executed and delivered by this Corporation and executed by the trustee named therein, the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Treasurer, the Secretary or any Assistant Treasurer or Assistant Secretary of this Corporation are hereby authorized to execute the Securities or effect the execution thereof by facsimile signature, in the name and on behalf of this Corporation and under its corporate seal (which may be facsimile), and such officers are hereby authorized to deliver, or cause to be delivered, to such trustee, for authentication, for purposes of original issue, the aggregate principal amount of Securities authorized

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in the Indenture, and that such trustee be requested thereupon to authenticate and deliver such Securities in the manner provided in the Indenture.

RESOLVED, that the Securities shall be in the form of registered Securities without coupons in denominations to be authorized by the Indenture.

RESOLVED, that, the Chief Executive Officer, the Chief Financial Officer, the President or any Vice President of this Corporation, and each of them, acting severally, are hereby authorized to deliver, or cause to be delivered, not exceeding \$350,000,000 aggregate principal amount of Securities to or upon the order of UBS Warburg LLC for the account of the Initial Purchasers named in the Purchase Agreement for the Securities against payment of the purchase price thereof, all in the manner and upon the terms and conditions contained in the Purchase Agreement.

RESOLVED, that The Bank of New York or any other duly appointed agent of this Corporation is hereby appointed Registrar and Paying Agent with respect to the Securities, to act in such capacities in accordance with the terms of the Indenture setting forth the duties of Registrars and Paying Agents acting thereunder, and the corporate trust office of such agent is hereby designated as the office or agency of this Corporation in the City of New York, New York, where Securities may be presented for payment, where notices and payments in respect of the Indenture and the Securities may be received and where Securities may be presented for registration, transfer or exchange.

RESOLVED, that the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Secretary or any Assistant Secretary of this Corporation, and each of them, are hereby authorized and directed to execute, acknowledge, verify, deliver, file and publish, in the name and on behalf of this Corporation, and under its corporate seal attested by its secretary or any assistant secretary, or otherwise, any and all applications, reports, statements, issuer's covenants, resolutions, consents to service of process, powers of attorney, appointments, designations and such other papers and instruments as may be required or desirable under the Blue Sky laws or Securities Acts of any or all of the States of the United States of America in order to register, qualify or exempt any or all of the Securities for issuance and sale to the general public in such states by this Corporation, initial purchasers or brokers and dealers, and to take any and all such further action which such officers or any of them may deem necessary or advisable in connection with any of the foregoing.

RESOLVED, that the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Secretary or the Treasurer of this Corporation, and each of them, are hereby authorized, empowered and directed to execute and deliver on behalf of this Corporation any and all certificates, orders, receipts and other documents, which may be under the corporate seal attested by the Secretary or any Assistant Secretary, and to take such steps and to perform such acts as may, in the judgment of any of them, be necessary or convenient to the carrying out of these resolutions and the consummation of the transactions contemplated hereby, and any

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such certificates, documents or papers executed or acts taken by any of them shall be conclusive evidence of their authority in so doing.

RESOLVED, that, subject to any limitations contained in the foregoing resolutions, the Pricing Committee appointed by the Board of Directors, consisting of Richard M. Scrushy and William T. Owens, by a writing signed by at least one of them, is hereby authorized to take any and all action which this Board of Directors has power to take and which such committee or such officers may deem advisable in connection with the proposed offering of the Securities authorized at this Meeting to be issued, including, without limitation, the fixing of the interest rates and redemption prices with respect to the Securities, the public offering prices thereof, the underwriting discount, the maturity dates and the covenants of the Company thereunder.

RESOLVED, that this Corporation create an issue of certain securities (the "Exchange Securities") to be offered in exchange for the Securities pursuant to the Registration Rights Agreement.

RESOLVED, that the Chairman of the Board and Chief Executive Officer, the Chief Financial Officer, the President and each Vice President of this Corporation, and each of them, are hereby authorized to cause to be prepared and to execute, in the name and on behalf of this Corporation, and to cause to be filed with the Securities and Exchange Commission, pursuant to the Securities Act of 1933, as amended, a Registration Statement on Form S-4 relating to the "Exchange Securities" and to cause to be filed with the Securities and Exchange Commission such amendments to such Registration Statement as any of such officers may deem necessary or advisable.

RESOLVED, that Richard M. Scrushy, Chairman of the Board and Chief Executive Officer of this Corporation, is hereby appointed as agent of this Corporation to receive notices and communications from the Securities and Exchange Commission with respect to the aforesaid Registration Statement, or any amendment thereof, and to exercise the powers enumerated under Rule 478 of the Rules and Regulations of the Securities and Exchange Commission under the Securities Act of 1933, as amended.

RESOLVED, that the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Treasurer, the Secretary or any Assistant Treasurer or Assistant Secretary of this Corporation are hereby authorized to execute the Exchange Securities or effect the execution thereof by facsimile signature, in the name and on behalf of this Corporation and under its corporate seal (which may be facsimile), and such officers are hereby authorized to deliver, or cause to be delivered, the Exchange Securities to the trustee under the Indenture, for authentication, and to take such other actions as shall be necessary and appropriate to effect the issuance and delivery of the Exchange Securities in exchange for the Securities.

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RESOLVED, that the Chairman of the Board and Chief Executive Officer, any Executive Vice President, any Senior Vice President, any Vice President, the Secretary and any Assistant Secretary of this Corporation, acting singularly, are hereby authorized and directed to take such action as they, acting upon advice of counsel, deem necessary or advisable to effect the redemption on or before October 30, 2000 of 100% of the outstanding principal amount of the Corporation's 9.5% Senior Subordinated Notes due 2001 in accordance with the terms set forth in the Indenture governing such Notes, and to execute and deliver such notices, documents and instruments as they may deem necessary or advisable to carry out the intent of this resolution.

RESOLVED, that the specific redemption date may be established by any such officer in conjunction with the Trustee under such Indenture.

**Grant of Options Under 1993 Consultants' Stock Option Plan**

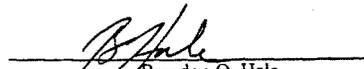
Mr. Scrusy asked that the Board ratify the grant of certain options to consultants to the Company under the 1993 Consultants' Stock Option Plan as of July 26. After discussion, upon motion duly made and seconded, the following resolution was unanimously adopted:

RESOLVED, that the following persons are hereby awarded options under the Corporation's 1993 Consultants' Stock Option Plan to purchase that number of shares following their names below, such options to vest at the rate of 25% per year commencing on July 26, 2001 and to have an exercise price of \$5.4375 per share, being the fair market value of the Corporation's common stock on the date of grant:

<u>Name</u>	<u>Number of Shares</u>
Gil L. Etheridge	10,000
Vincent "Bo" Jackson	10,000
Herschel Walker	10,000

There being no further business to transact, the Meeting was adjourned.

  
Richard M. Scrusy  
Chairman of the Board  
and Chief Executive Officer

  
Brandon O. Hale  
Senior Vice President  
and Secretary

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EXHIBIT A

Tab 30

# **HEALTHSOUTH Audit Committee Charter**

**HHEC 18-02161**

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**HEALTHSOUTH AUDIT COMMITTEE CHARTER**

**Organization**

This charter governs the operations of the Audit Committee. The committee shall review and reassess the charter at least annually and obtain the approval of the Board of Directors for any revisions. The committee shall be appointed by the Board of Directors and shall comprise at least three directors, each of whom are independent of management and the Company. Members of the committee shall be considered independent if they have no relationship that may interfere with the exercise of their independence from management and the Company, as determined by the Board of Directors in its business judgment. All committee members shall be financially literate, and at least one member shall have accounting or related financial management expertise.

**Statement of Policy.**

The Audit Committee shall provide assistance to the Board of Directors in fulfilling its oversight responsibility to the Company's stockholders, the investment community, and others relating to the Company's financial statements and the financial reporting process, the systems of internal accounting and financial controls, the internal audit function, and the annual independent audit of the Company's financial statements. In so doing, it is the responsibility of the committee to maintain free and open communication between the committee, independent auditors, the internal auditors and management of the Company. In discharging its oversight role, the committee is empowered to investigate any matter brought to its attention with full access to all books, records, facilities, and personnel of the Company and the power to retain outside counsel or other experts for this purpose.

**Responsibilities and Processes**

The primary responsibility of the Audit Committee is to oversee the Company's financial reporting process on behalf of the Board and report the results of its activities to the Board. Management is responsible for preparing the Company's financial statements, and the independent auditors are responsible for auditing those financial statements. The committee in carrying out its responsibilities believes its policies and procedures should remain flexible, in order to best react to changing conditions and circumstances. The committee should take the appropriate actions to set the overall corporate "tone" for quality financial reporting, sound business risk practices, and ethical behavior.

The following shall be the principal recurring processes of the Audit Committee in carrying out its oversight responsibilities. The processes are set forth as a guide with the understanding that the committee may supplement them as appropriate.

- The committee shall have a clear understanding with management and the independent auditors that the independent auditors are ultimately accountable to the Board and the Audit Committee, as representatives of the Company's stockholders. The committee shall have the ultimate authority and responsibility to evaluate and, where appropriate, recommend the replacement of the independent auditors. The committee shall discuss with the auditors their independence from management and the Company and the matters included in the written disclosures required by the Independence Standards Board. Annually, the committee shall review and recommend to the board the selection of the Company's independent auditors.

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- The committee shall discuss with the internal auditors and the independent auditors the overall scope and plans for their respective audits including the adequacy of staffing and compensation. Also, the committee shall discuss with management, the internal auditors and the independent auditors the adequacy and effectiveness of the accounting and financial controls. Further, the committee shall meet separately with the internal auditors and the independent auditors, with and without management present, to discuss the results of their examinations.
- The committee shall review the interim financial statements with management and the independent auditors prior to the filing of the Company's Quarterly Report on Form 10-Q. Also, the committee shall discuss the results of the quarterly review and any other matters required to be communicated to the committee by the independent auditors under generally accepted auditing standards. The chair of the committee may represent the entire committee for the purposes of this review.
- The committee shall review with management and the independent auditors the financial statements to be included in the Company's Annual Report on Form 10-K, including the independent auditors' judgment about the quality, not just acceptability, of accounting principles, the reasonableness of significant judgments, and the clarity of the disclosures in the financial statements. Also, the committee shall discuss the results of the annual audit and any other matters required to be communicated to the committee by the independent auditors under generally accepted auditing standards.

**Scope of Responsibility**

The Audit Committee is responsible for the duties set forth in this charter but is not responsible for either the preparation of the financial statements or the auditing of the financial statements. Management has the responsibility for preparing the financial statements and implementing internal controls, and the independent auditors have the responsibility for auditing the financial statements and monitoring the effectiveness of the internal controls. The review of the financial statements by the Audit Committee is not of the same quality as the audit performed by the independent auditors.

<DOCUMENT>  
 <TYPE>DEF 14A  
 <SEQUENCE>1  
 <FILENAME>nps.txt  
 <DESCRIPTION>DEF 14A  
 <TEXT>

**Tab 31**

SCHEDULE 14A INFORMATION  
 Proxy Statement Pursuant to Section 14(a) of the  
 Securities Exchange Act of 1934

Filed by the Registrant    
 Filed by a Party other than the Registrant

Check the appropriate box:  
 Preliminary Proxy Statement  
 CONFIDENTIAL, FOR USE OF THE COMMISSION ONLY (AS PERMITTED BY RULE  
 14A-6(E)(2))  
 Definitive Proxy Statement  
 Definitive Additional Materials  
 Soliciting Material Pursuant to Rule 14a-11(c) or Rule 14a-12

HEALTHSOUTH CORPORATION  
 -----  
 (Name of Registrant as Specified In Its Charter)

HEALTHSOUTH CORPORATION  
 -----  
 (Name of Person(s) Filing Proxy Statement)

Payment of Filing Fee (Check the appropriate box):  
 No fee required.  
 Fee computed on table below per Exchange Act Rules 14a-6(i)(14) and 0-11.

(1) Title of each class of securities to which transaction applies: N/A  
 -----

(2) Aggregate number of securities to which transaction applies: N/A  
 -----

(3) Per unit price or other underlying value of transaction computed  
 pursuant to Exchange Act Rule 0-11:  
 N/A  
 -----

(4) Proposed maximum aggregate value of transaction:  
 N/A  
 -----

(5) Total fee paid: N/A  
 -----

Fee paid previously with preliminary materials.  
 -----  
 Check box if any part of the fee is offset as provided by Exchange Act Rule  
 0-11(a)(2) and identify the filing for which the offsetting fee was paid  
 previously. Identify the previous filing by registration statement number,

4

&lt;PAGE&gt;

Richard M. Scrushy described elsewhere in this Proxy Statement (see "Executive Compensation and Other Information -- Compensation Committee Report on Executive Compensation -- Chief Executive Officer Compensation"); and except that we initially agreed to appoint Mr. Gordon to the Board of Directors in connection with the SCA merger. There are no family relationships between any Directors or executive officers of HEALTHSOUTH. None of our Directors or executive officers is a party to any material proceedings adverse to us or any of our subsidiaries or has a material interest adverse to us or any of our subsidiaries. The Board of Directors held a total of seven meetings during 2001.

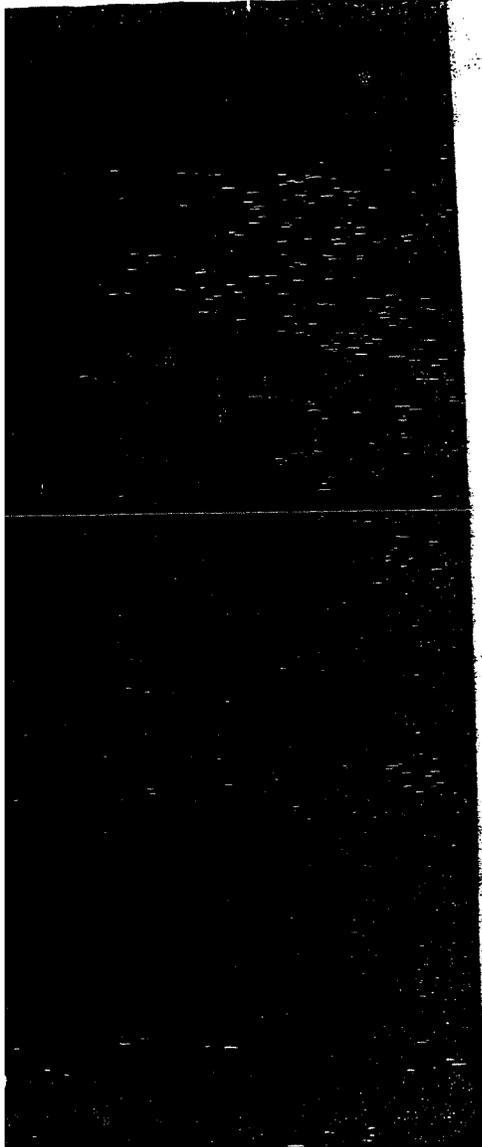
We have Employment Agreements with some of our executive officers in addition to Mr. Scrushy. See "Executive Compensation and Other Information -- Compensation Committee Report on Executive Compensation -- Other Executive Employment Agreements". Except for such Employment Agreements and except for the broad-based retirement plans described under "Executive Compensation and Other Information -- Retirement Investment Plan" and "Executive Compensation and Other Information -- Employee Stock Benefit Plan" and the Executive Deferred Compensation Plan described under "Executive Compensation and Other Information -- Deferred Compensation Plan", there are no compensatory plans or arrangements with respect to any such executive officer which result or will result from the resignation or retirement of such executive officer or any other termination of such executive officer's employment with HEALTHSOUTH and its subsidiaries or from a change in control of or from a change in such executive officer's responsibilities following a change in control of HEALTHSOUTH.

The Board of Directors currently has four standing committees: the Audit Committee, which is responsible for reviewing all reports made by our auditors and monitoring internal controls; the Compensation Committee, which is responsible for reviewing our compensation programs and administering our stock option plans; the Corporate Compliance Committee, which is responsible for establishing and reviewing our Corporate Compliance Program and otherwise ensuring that we conduct our operations in compliance with federal, state and local laws and regulations; and the Nominating Committee, which is responsible for proposing and recommending to the Board of Directors potential candidates for the Board. During 2001, the Audit Committee consisted of C. Sage Givens, Larry D. Striplin, Jr. and George H. Strong, Chairman; the Compensation Committee consisted of John S. Chamberlin, Phillip C. Watkins, M.D. and Larry D. Striplin, Jr., Chairman; the Corporate Compliance Committee consisted of Charles W. Newhall IIII, Phillip C. Watkins, M.D., Brandon O. Hale and Joel C. Gordon, Chairman; and the Nominating Committee consisted of C. Sage Givens, Charles W. Newhall III and George H. Strong. All members of such committees are outside directors, except for Mr. Hale, who is our Senior Vice President - Administration and Secretary and Corporate Compliance Officer. All members of these committees continue to serve in such capacities.

The Audit Committee met separately from the Board once in 2001 and, through its Chairman, reviewed and approved our financial statements each quarter before the filing of our Quarterly Reports on Form 10-Q. The Compensation Committee met once and acted by unanimous written consent three times in 2001. The Corporate Compliance Committee met three times in 2001. The Nominating Committee did not meet in 2001.

There are no other standing audit, nominating or compensation committees of the Board of Directors.

#### BOARD COMPENSATION



Tab 32

BOD

8/8/02

BOD

8/8/02

Ras. SSC CSG JCG CWR

LOS WTO GHS PCW  
Halya

Grada Hlc, Smith, M:lay

Audit Report

Greg Smith

# Audits

Type Audits

Asst. EOP

Bitly Review For CIA

Com. rate ↓ 2%

HCAR

Questions

Compliance Report

Soal book - Got

Boff - Review

Treasury Review

Tull M:Vay

- Comments on Conference Call - All parties

- with earnings release

Recent Events

- 4TB 10 year Sr. Notes
- New \$1.25B bank facility
- Returned \$200m in Synthetic loans

Strong Liquidity Position

- 1-2B available under new bank facility
- New bank provides ample liquidity to plant last summer
- Reaffirmed stock repurchase program <sup>2007</sup>
- No off balance sheet financing issues
- No significant maturities until 2007

Liquidity Summary

↳ Refinance plan Goals met

- Capital Transactions
- Review of financial ratios

Investor Relations issues

- HRC Trade at discount to peers
- Top 10 holders of HRC
- Current analyst coverage
- Target list for new coverage

Treasury Summary

## Financial Review - Walter Smith

## Income Statement Highlights

- Revenue
- EBITDA
- Net Income
- Earnings per Share 28¢
- Dividend Net Revenue
- Outpatient Visits
- O.P. Revenue
- Surgery Cases
- Surgery Revenue
- Diagnostic Scans
- I.P. Discharges up 5% on program
- I.P. Revenue
- Medial Center Days
- Medial Center Revenues

RMS

- Overview of history of HealthSouth + competitors
- Evaluation of surgery business + strategy for spinning out surgery division +
- Dis
- Discussion of CMS transitional changes regulation of group therapy / concurrent therapy in Outpatient Medicare reimbursement

★ We need to get the input on revenue  
& examine it to the street.

→ Ross asked Bill McCall to join us  
to present plan / 3 others / Ted O'Neil, Paul  
I. Vintalpin, Hugh O'Hare

Project Orion -  
break for lunch - Discussion continued during lunch

↳ Continued discussion after lunch on  
Project Orion

\* Discussion of Mgt Structure.

~~Project Orion~~  ~~Arthur~~ Strip  
2<sup>nd</sup> ~~and~~ ~~Cherubino~~

approved

★ Add Discussion by Ross & WTD of CMS Transmitted (to)  
should meet with CMS to clarify (to) and  
assess impact on DAC

Taylor COO  
Wade CFO  
R. Davis Tracy  
Mark Controller

Approved Promotions  
WTD - CFO  
Tadd - CFO

move Strip  
& 2<sup>nd</sup> Watkins

RMS

Discussion of Executive Loan  
Repayments

RMS report with exchange of stock

Adjourn

2:55 PM

Brad,

- 1) Floor plan 4 North
- 2) PAF for Paul



**CONFIDENTIAL  
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HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
AUGUST 26, 2002  
MINUTES Tab 33**

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated August 26, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, William T. Owens, President and Chief Operating Officer of the Corporation, Joel C. Gordon, Phillip C. Watkins, M.D., Larry D. Striplin, Jr., George H. Strong, John S. Chamberlin and C. Sage Givens. The following guests were also present: Brandon O. Hale, Executive Vice President – Administration and Secretary, Malcolm E. McVay, Executive Vice President and Treasurer of the Corporation, Weston L. Smith, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, and Larry D. Taylor, President and Chief Operating Officer – Ambulatory Services of the Corporation, William McGahan, Rod O'Neill, Hugh O'Hare, Scott Wollard, John Wagner and Rick Leaman of UBS Warburg, LLC, and Samuel H. McGarr and Tom Avent of KPMG. With the exception of Mr. Leaman, everyone was physically present in the Corporation's Board Room. Mr. Leaman participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 4:00 p.m. C.D.T.

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Project Crimson Strategic Alternatives Discussion

UBS Warburg Presentation

Mr. Scrushy asked Mr. McGahan and his associates to lead the Board through a strategic alternative discussion on Project Crimson. UBS Warburg began with a review of a segment valuation and a discussion of ways to improve business focus by considering several alternatives, including the sale of the diagnostic facilities combined with the split off of the surgery centers, the sale of the surgery centers, the spin-off or split-off of the surgery centers (with or without IPO) and the sale of the diagnostic facilities. UBS Warburg then presented to the Board a debt analysis and discussed how the current debt profile impacted the alternatives being considered. In closing, Mr. McGahan and the UBS Warburg team presented a summary of the timeline of events to take place and led a discussion of the key separation decisions that needed to be made by the Corporation.

KPMG Opinion

Mr. Scrushy requested Mr. McGarr and Mr. Avent give their opinion on whether there is a justifiable business reason for either the spin off or split-off of the surgery division, thus allowing a tax-free transaction. Mr. Avent responded that he is very comfortable that there are several justifiable business reasons for the spin-off or split-off transaction which would allow a tax-free transaction to be effected.

**CMS Transmittal 1753**

Mr. Scrushy asked Mr. Owens to review with the Board the timeline of events resulting from CMS Transmittal 1753. Mr. Owens stated that CMS Transmittal 1753 was posted to Part B carriers only on May 17, 2002 and the Corporation received a copy of the Transmittal from a third party in early June. The Corporation forwarded a copy to Blue Cross of Alabama (the Corporation's fiscal intermediary), who advised the Corporation that the Transmittal did not apply to HEALTHSOUTH. The Corporation requested a formal letter from Blue Cross of Alabama. After not having received one, a meeting was scheduled for July 18, 2002 with CMS and reimbursement representatives from HEALTHSOUTH. That meeting generated more questions than answers. Mr. Owens stated that he had believed the Transmittal might apply to the Corporation's outpatient services in freestanding

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outpatient centers. He informed Mr. Scrusby on August 6 that it might apply to such services in freestanding outpatient centers and the impact could be \$15,000,000 - \$20,000,000. Mr. Scrusby stated that he had advised Mr. McVay and subsequently Mr. Owens to go back to CMS for better clarification. The meeting on August 15 did not answer all questions regarding Transmittal 1753, but answered enough questions to allow the Corporation to prepare an analysis of the potential impact.

Mr. Owens advised the Board that he was comfortable with the chronology of events and that the Corporation had been working diligently since the August 15 meeting to assess the impact of the Medicare changes.

Mr. Scrusby and Mr. Owens advised the Board that the estimated impact on revenue of CMS Transmittal 1753 would be \$175,000,000 per year, and that the Corporation would be putting out a press release disclosing this on Tuesday, August 27.

**SCA Update**

Mr. Taylor thanked Messrs. Scrusby and Owens and the Board for their support and made comments regarding SCA's management team and updated the Board on current initiatives and development activities.

All guests left the room at this time for the Board to continue discussions regarding Project Crimson and CMS Transmittal 1753. After discussions, the Board, upon motion duly made and seconded, gave preliminary approval to management to proceed with development of a plan for a separation transaction involving the surgery center division. There were no votes cast against the motion. It was noted that the promotions and responsibility changes involving Mr. Owens, Mr. Smith and Mr. McVay that were approved at the August 8 meeting would become effective as of this meeting.

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There being no further business to transact, the Meeting was adjourned.



---

Richard M. Scrusby  
Chairman of the Board

HS-71307.1



---

Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

B00

8/24/02

Tab 34

HHEC 293-0465  
Confidential Treatment  
Requested by HealthSouth Corp.

BOD  
8/26/02

RMS WTO JEE PCW  
KBS, GS, SE, SG

Guest - W. Smith B. Holt T. McVay  
B. Horton L. Taylor

KRMK - Sam McEwan Tom  
UBS - (H) - B. McEwan Mother

4:00 PM CDS

UBS Presentation - Bill McEwan Rick Bayman  
Strategic Alternatives Discussion

③ Segment Voluntary Rod O'Neal UBS

A) Discussed CMS Transmitted letter and  
impact on business

B) Also discussed positive impact of Transmitted  
letter on our DOT case

KPAG H Feels there is favorable business case  
for the Specialty SPLIT OFF

→ Analysis of All options

(11)

Debt Analysis

- Debt Capital Structure
- Financing Considerations

Time line

Discuss

Executive Studies - Alternatives

- 1) Spin-off or split off
- 2) Can tax free status be achieved
- 3) What are the appropriate capital structures or dividend policies
- 4) Pursue IPO before Full Separation?

★

RMS  
part 10Timeline of CMS Transmittal

HHEC 293-0467  
Confidential Treatment  
Requested by HealthSouth Corp.

WTO → 1) Dated May 17

2) We received early June

3) We gave to the (intermediate) - *Michael Burt*  
it did not apply to us - would  
not put in worksheet

4) submit meeting with CMS July 18

meeting generated more questions than answers

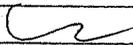
- Back to CMS Aug 16 - Once agreed we don't have all questions answered but enough to begin our analysis of impact
- We have chemistry of events that we are comfortable with
- We did not bill Malone for 1st 45 days at etc until we got clarification

Bill Horton →

2

Guest leave room except T. McKay, L. Taylor, W. Smith, B. Hoke, D. Hoke

Discussion



HHEC 293-0468  
Confidential Treatment  
Requested by HealthSouth Corp.

Thanks board, Robert + Bill for their support

Larry Taylor

- Comments are Mgt Team + members for Surgery Company
- Develop activities

Bill Owen + Camacho are strong to weather  
in retail company - but good  
cash flow + good Mgt Team  
to come out very strong a  
positive -

Motion Watkins  
Stephan 2nd

All Guest including Bob left the  
room for Board to continue  
discussions.

★ Get with WTO + RMS to see what  
needs to be added to Board  
minutes.

> "Discussion continued then motion  
approved with no votes against  
the motion"

et (6228 PM)

Draft

HealthSouth Corporation  
 Meeting of the Board of Directors  
 August 26, 2002  
 Minutes

A Meeting of the Board of Directors of HealthSouth Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Notice of Meeting dated August 26, 2002, a copy of which is attached to these minutes.

Board Member Present: RMS WTD JCK PC  
 WDS GHS SSC CSG

Guest: W. Smith, B. Hale, J. M. V.  
 B. Hester, L. Taylor

KRAG - Sam McMan  
 Tom Adent @

(Adent)

WBS Wishing - Bill McMan  
 5 others 2 from

→ Rod O'Neill, Hugh O'Neil, Scott Ballard, John Kops  
 and Rick Keenan (Rick Keenan via telephone)

Richard M. Secombe acted as Chairman of the Meeting and Brandon or Hale acted as Secretary.

The meeting was called to order at 4:00 PM  
COT

UBS Working

Project Crimson Strategic Alternative Discussion

Mr. Seandy asked Mr. McEwan <sup>and his associates with</sup> UBS Working to lead the <sup>Board</sup> through a Strategic Alternative Discussion on Project Crimson. UBS Working began with a review of a segment valuation and a discussion of ways to improve business focus ~~the~~ by considering several alternatives including the sale of Diagnostica <sup>contingent with</sup> split-off of Surgery Centers, the sale of Surgery Centers, the spin-off or split-off of Surgery Centers (with or without IFO) and the sale of Diagnostica. UBS Working then presented to the Board a debt analysis and discussed how the current debt profile impacted the alternatives being considered. ~~The timeline for execution with~~ a summary of the timeline of events and a discussion of key separation decisions to be made by the Company. In closing Mr. McEwan and the UBS Working team presented a summary of the timeline of events to take place and lead a discussion of the key separation decisions that would be made by the Corporation.

KPMG

~~At the~~ Mr. Scarsky requested ~~from~~ Mr. McEwen and Mr. Adant with KPMG to give their opinion whether they felt there is a justifiable business reason for either the spin off or split off of the Surgery Division thus allowing a tax free transaction. Mr. Adant responded to the point that he ~~was~~ is very comfortable that there ~~are~~ several justifiable business reasons for the spin or split off transaction which would allow a tax-free status to be achieved.

CMS Transmitted 1253

HHEC 293-0472  
Confidential Treatment  
Requested by HealthSouth Corp.

Mr. Scarsky advised the Board that Company representatives had again met with CMS and Board and asked Mr. Owens to review with the Board the timeline of events resulting from CMS Transmitted 1253. Mr. Owens stated that CMS Transmitted 1253 to Carver's on May 17, 2002 and the Company a copy of the transmitted from a third party in early June. The Company furnished a copy to Blue Cross of Alabama (our fiscal intermediary).

and they advised us that it did not apply to us. The Company requested a Form 1099 from Blue Cross of Alabama but did not receive one so a meeting was scheduled on July 18, 2002 with CMS and Reimbursement Representatives from HealthSouth. The meeting on July 18 generated more questions the answers therefore a subsequent meeting was scheduled for August 16, 2002. The meeting on August 16 did not answer all questions regarding Transmittal 1253 but answered enough questions to begin HealthSouth's analysis of impact.

Mr. Owens advised the Board that he was comfortable with the chronology of events and ~~that~~ the Company had been working diligently since the August 16, 2002 meeting to assess impact of the Medicare changes. Owens also advised the Board that he

Mr. Scrimby and Mr. Owens advised the Board that the estimated impact on Revenue of CMS Transmittal 1253 would be \$175 million per year.

SCA Update

Mr. Taylor thanked Messrs. Scruby and Owens and the board for their support and updated the board ~~on~~ made comments regarding SCA's management team and updated the board on current initiatives and development activities.

All guests left the room at this time for the Board to continue discussions regarding Project Crimson and CMS Transaction 1252. After discussions a motion was made ~~to~~ and approved to enter split ~~to~~ split the Surgery Division ~~to~~ There were no votes cast against the motion.

There being no further business to discuss, the meeting was adjourned.

**From:** Horton, Bill  
**Sent:** Sunday, September 29, 2002 4:33 PM **Tab 35**  
**To:** Hale, Brad, Smith, Weston  
**Subject:** Audit Committee

---

I am finding no record that I was ever given drafts of Audit Committee minutes for 2001 (after March 27) or 2002. Do either of you know the status of Audit Committee minutes?

**From:** Smith, Weston  
**Sent:** Monday, October 7, 2002 9:49 AM  
**To:** Harris, Emery Tab 36  
**Cc:** Horton, Bill  
**Subject:** FW: Audit Committee

---

Emery, please forward copies of the minutes to Bill.

Bill, copies of the minutes were sent to George Strong last week, he had requested them in response to Fulbright. We have 2002 minutes, none were prepared in 2001.

-----Original Message-----  
**From:** Horton, Bill  
**Sent:** Monday, October 07, 2002 8:45 AM  
**To:** Smith, Weston  
**Subject:** Audit Committee

Just a reminder that I need drafts of all audit committee meeting minutes after Orlando 2001. Thanks.

**From:** Horton, Bill  
**Sent:** Monday, October 21, 2002 5:10 PM  
**To:** Watson, Gail  
**Subject:** RE:

---

That is correct.

-----Original Message-----  
**From:** Watson, Gail  
**Sent:** Monday, October 21, 2002 4:10 PM  
**To:** Horton, Bill  
**Subject:** FW:

Please confirm.

-----Original Message-----  
**From:** RPMAY@aol.com [mailto:RPMAY@aol.com]  
**Sent:** Monday, October 21, 2002 11:18 AM  
**To:** Watson, Gail  
**Cc:** bobmay9788@msn.com; JackChamberlin@aol.com; jfhanson@hampshireco.com  
**Subject:** Re:

Gail just so I understand your email correctly. The audit committee is the only one with an existing charter. The compliance committee, compensation committee, nominating committee do not have a formal charter. Would you please check with Bill Horton to verify this fact. Thanks for your help. bob

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**Fulbright & Jaworski L.L.P.**

A Registered Limited Liability Partnership  
666 Fifth Avenue, 31st Floor  
New York, New York 10103-3198  
www.fulbright.com

**MEMORANDUM**

Tab 38

ATTORNEY-CLIENT PRIVILEGED MATERIAL  
ATTORNEY WORK PRODUCT DOCTRINE APPLIES

**TO:** William W. Horton  
**FROM:** Hal M. Hirsch  
Richard W. Beckler  
**DATE:** March 6, 2003  
**RE:** Recollection of Proceedings of October 22, 2002 Board of Directors Meeting of  
HealthSouth Corporation

---

You have requested that we provide you with a memorandum containing our recollections of the proceedings of the meeting of the Board of Directors of HealthSouth that was held on October 22, 2002 (the "Meeting"). Mr. Hirsch attended the Meeting in person and Mr. Beckler attended the Meeting by conference telephone.

We remind you that we were not requested to take minutes of the Meeting and, therefore, did not undertake to prepare any minutes of the Meeting. Please also note that our recollection of the Meeting's proceedings may not accurately reflect the full content of the matters discussed at the Meeting and may omit some of the discussions held during the course of the Meeting. This memo should not be considered to be the minutes of the Meeting and the recollection of the proceedings provided in this memo is not intended to constitute advice as to the appropriate content of the minutes of the Meeting.

Our recollection is that the board members who attended the Meeting were Jack Chamberlin, Sage Givens, George Strong, Charles Newhall, John Hanson, Robert May, Larry Striplin, Richard Scrushy, and Phillip Watkins. Lanny Davis, of Patton Boggs LLP, also was a guest at the Meeting and was present by conference telephone. We cannot assure you, however, that this is a full and accurate list of the persons who attended the Meeting.

Set forth below is a synopsis of our recollection of the proceedings of the Meeting:

At the beginning of the Meeting, Mr. Scrushy stated that the Fulbright & Jaworski L.L.P. report would take up most of the Meeting.

Mr. Scrushy then reported that a national survey conducted by a corporate governance firm which graded public companies gave HealthSouth a grade of 75%; it

45289291.1

**HHEC 18-02313**

March 6, 2003  
Page 2

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gave The Walt Disney Company a grade of 5%. According to this survey, HealthSouth's grade put HealthSouth in the top 90% of companies surveyed.

Mr. Scrusy reported that he met with Herb Denton in New York, and that they had a good exchange. He stated to Mr. Denton that HealthSouth is cooperating with the SEC. Mr. Denton would propose individuals to sit on HealthSouth's Board of Directors and/or the corporate governance committee. Mr. Denton told Mr. Scrusy that he wanted to work with HealthSouth, although Mr. Scrusy mentioned to the Board that in the past Mr. Denton had gone hostile with other companies.

Mr. Scrusy informed the Board that he had met with Stephens, an Arkansas investment banking firm.

Mr. Scrusy reported that he had discussions with AIG, and at that point in time, they had only exchanged documents. AIG has a product which would relieve a company of potential litigation liability for a set price. Mr. Scrusy said that senior management of AIG discussed with Mr. Scrusy the possibility of HealthSouth buying out its potential litigation liability and AIG taking the risk of a judgment in the litigation. AIG indicated that they would be willing to review HealthSouth's litigation.

Mr. Hirsch then stated that Fulbright & Jaworski L.L.P. had prepared a report based on the firm's review of certain matters for the time period December 2001 through September 2002. Mr. Hirsch read the report of Fulbright & Jaworski L.L.P. to the Board. Following his reading of the report, in response to an inquiry, Mr. Hirsch stated that, as requested, there are no restrictions on the Board with respect to the use of Fulbright & Jaworski L.L.P.'s report, but he advised that because the report contains attorney-client privileged and attorney work product material, releasing the report or a summary thereof could result in a waiver of such privileges as to the matters contained in the report.

Joel Gordon's letter to Richard Scrusy was also discussed and Mr. Davis read a proposed response to Mr. Gordon. The Board felt that it was best not to respond in writing to Mr. Gordon's letter, though no decision was made.

Thereafter, a discussion ensued concerning additional data the Board sought concerning the Fulbright & Jaworski L.L.P. report. Mr. Scrusy suggested that, until this follow-up is completed, a press release should not be issued relating to the report of Fulbright & Jaworski L.L.P.

Mr. May inquired as to the contents of a possible press release on the matters contained in the Fulbright & Jaworski L.L.P. report. Mr. Davis discussed options for a press release.

Mr. May suggested that the chronology section of the report should not be released at that time because the Company's investigation was on-going and because there was a reference in the report to document destruction by Company personnel. Mr. Scrusy requested that Robert May, John Hanson and Fulbright & Jaworski L.L.P. investigate the document destruction matter further and report back to the Board in the next two weeks on the matter. Mr. Scrusy stated that it is important to understand what

March 6, 2003  
Page 3

CONFIDENTIAL  
TREATMENT REQUESTED

was destroyed and that he wanted clarification on the issue. He indicated that employees had been told not to destroy any documents. It was also discussed that it was possible that the document destruction was purely routine, because of HealthSouth's obligations under federal law to destroy patient information. Mr. Scrusy stated that he ordered the removal of all shredders from HealthSouth's corporate offices, and that such shredders were removed upon his request.

Mr. Scrusy requested that Fulbright & Jaworski L.L.P. also investigate further as to whether Transmittal 1753 or the group therapy policy addressed therein was discussed at the July 8, 2002 Monday Morning Meeting.

Mr. Hirsch stated that an accounting firm had been engaged to review the financial impact of Transmittal 1753.

The Board agreed, without adopting a resolution, that the Fulbright & Jaworski L.L.P. report would not be released to the press or sent to the SEC at that time, but that this should be done sooner rather than later.

The Board was reminded that the earnings release call was scheduled for November 5, and that every effort should be made to get the answers and report them prior to that date.

The Board then discussed the scheduling of its next meeting and decided it should be held on Tuesday, October 29, 2002.

HMH  
RWB

PATTON BOGGS LLP  
ATTORNEYS AT LAW

February 14, 2003

Tab 39

VIA FEDERAL EXPRESS

Mr. Richard M. Scrushy  
Chairman of the Board  
HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

Enclosed is a copy of minutes that Adam Goldberg took of the October 22, 2002 executive session of the Board of Directors. I wanted to ensure that you had a copy of the enclosed for two reasons: (1) it reflects the seriousness and appropriateness with which you and the Board of Directors have approached the applicable issues; and (2) in case it is responsive to any document requests in the civil litigation or government inquiries. I am sending it to you rather than Bill Horton because the minutes are of an executive session in which Bill did not participate.

Please call me if you have any questions.

Best regards,

  
Lanny J. Davis

Enclosure

Doc. 683777

**HHEC 247-1855**  
Confidential Treatment  
Requested by HealthSouth Corp.

**HEALTHSOUTH CORPORATION**  
**Minutes of Executive Session Board Meeting: October 22, 2002**

This Board meeting was held in executive session – no officers of the company attended the meeting. The meeting was held by conference call, with certain Board members present at HealthSouth headquarters in Birmingham. The following Board members attended the meeting and were present at the Birmingham headquarters: Richard Scrusby (Chairman); Robert May; Larry Striplin, Jr.; and Phil Watkins. The following Board members participated in the meeting by telephone: Jon Hanson; C. Sage Givens; Jack Chamberlain; Joel Gordon; and George Strong. C. Sage Givens missed portions of the meeting. Also participating in the meeting were the following outside counsel: Lanny Davis (Patton Boggs); Dick Beckler (Fulbright & Jaworski); Hal Hirsch (Fulbright & Jaworski); and Adam Goldberg (Patton Boggs).

The Chairman called the meeting to order and described certain corporate matters. The Chairman informed the Board about the Chairman's meeting with Bert Denton and described it as positive. The Chairman also informed the Board about his meeting with AIG about the possibility of AIG assuming the liability risk from outstanding litigation for a set fee. The Chairman explained to the Board that he will be continuing discussions with AIG on that matter.

The Chairman then asked Lanny Davis, outside counsel, to provide additional information on the Denton and AIG meetings. Mr. Davis provided additional details on the meeting and on subsequent conversations that Mr. Davis had with Mr. Denton. Mr. Davis also provided additional information on the Chairman's meeting with AIG.

The Chairman then asked Hal Hirsch, outside counsel, to present findings of Fulbright & Jaworski to the Board related to the timing of the Chairman's stock transactions in May and July. Mr. Hirsch described his law firm's inquiry, cautioned the Board about privilege issues related to dissemination of Fulbright's findings, and read a Fulbright & Jaworski report to the Board. A copy of the report read to the Board is attached to these minutes.

Following Mr. Hirsch's reading of the report, the Chairman then asked the Board if it had questions for outside counsel. Mr. Strong asked a question about a potential news release and Mr. Davis responded. The Chairman then asked Mr. Hirsch why no one got a copy of the report prior to the meeting and Mr. Hirsch explained that he wanted to avoid any appearance that his law firm's findings were influenced.

The Chairman then proposed that Robert May and Jon Hanson review the report and back-up materials collected by Fulbright & Jaworski, take comments from Board members, and report to the Board at a meeting to be held on October 29, 2002 on matters such as whether disciplinary action should be taken.

The Chairman also stated that the document destruction issues raised in the report must be pursued quickly. Mr. Hirsch explained that it is important for the Board to note that the company destroys certain documents in the normal course and practice to prevent competitors from getting information. Mr. Hirsch cautioned the Board that no one should jump to rash

conclusions. The Board then discussed related issues and Mr. Hirsch stated that Fulbright & Jaworski would supplement the report with respect to the document destruction issue. Mr. Hirsch reported to the Board that on the day that Mr. Hirsch informed the Chairman about document destruction, the Chairman ordered that the company's security office disconnect all shredders and lock them up in a room monitored by security.

Mr. Stripland then asked certain questions regarding the company's estimates of the financial impact of the May 2002 CMS rule change and the Chairman responded. The Chairman explained that FTI and Fulbright & Jaworski were examining the accuracy of the company's \$175 million EBITDA estimate and that the Board should receive a report on such matters in the next week or two.

Robert May then informed the Board about certain matters relating to the Corporate Governance Committee chaired by Mr. May. Mr. May explained that he was working out matters with Barbara Franklin, Jack Kemp, and Connie Mack regarding their potential service as advisers to the Corporate Governance Committee. Mr. May also explained that the Committee was holding discussions with search firms to identify potential independent Board members.

Mr. May then asked Hal Hirsch a series of questions regarding Fulbright and Jaworski's findings as to when the Chairman, the Board, and members of the Compensation Committee were informed about certain matters. Mr. Hirsch responded.

The Chairman then ended the meeting.



F T I

FTI Consulting  
 Martin L. Cohen  
 1201 Eye Street  
 NW Suite 400  
 Washington, DC 20005  
 Telephone (202) 312 9230  
 Facsimile (202) 312 9108

TO: William Owens  
 President and Chief Executive Officer  
 HealthSouth Corp.

FROM: Martin L. Cohen, FTI Consulting Tab 40

DATE: November 6, 2002

RE: Fulbright & Jaworski Report - Open Items and Follow-up Questions From  
 Earnings Announcement

Dear Mr. Owens:

In order to finalize our report to Fulbright and Jaworski, we have prepared the following information request list. The list combines information outstanding from our fieldwork as well as new requests based on metrics that the Company released in Tuesday's earnings announcement. With respect to the latter, we need to better understand how the metrics released in the earnings announcements reconcile to the information in our report.

The following are key economic and statistical metrics that were referenced in your third quarter call:

- i. 3Q2002 to 3Q2002 17% decline in outpatient rehabilitation revenue.
- ii. 3Q2001 to 3Q2002 14% decline in outpatient rehabilitation volume.
- iii. 3Q2001 to 3Q2002 2.2 M to 2.058 M decline in outpatient rehabilitation visits.
- iv. 3Q2001 to 3Q2002 8.3% decline in outpatient rehabilitation visits.
- v. 3Q2001 to 3Q2002 3.8% decline in "same store" outpatient rehabilitation visits.
- vi. \$98/visit to \$89/visit decline in net revenues per visit.
- vii. \$23M impact due to Transmittal 1753.
- viii. 2Q2002 to 3Q2002 \$34M-volume impact.
- ix. 2Q2002 to 3Q2002 11K decline in referrals.
- x. 2Q2002 to 3Q2002 visits per discharge decline of one per discharge.
- xi. \$10M impact on inpatient division due to Transmittal 1753.

To facilitate the reconciliation of the above metrics with our report we would like the following information:

1. Clarification regarding which of these metrics refers to: (i) freestanding clinics, (ii) hospital outpatient and (iii) hospital satellite facilities;

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 Subject to Attorney Client and Attorney Work Product Privileges

Confidential Treatment  
 Requested by  
 HealthSouth Corp.

HHEC 44-1119



William Owens  
November 6, 2002 Page 2

2. Supporting documentation and the opportunity to meet with the staff who prepared the above mentioned metrics;
3. Identification of any non-recurring or one-time contractual adjustments and/or changes to reserves for doubtful accounts during 3Q2002?
4. Revenue reconciliation's (at the detail trial balance level) for outpatient rehabilitation including: (i) freestanding clinics, (ii) hospital outpatient and (iii) hospital satellite facilities) for 3<sup>rd</sup> Qtr 2002 and 3<sup>rd</sup> Qtr 2001. As part of this analysis we would like to see the breakout, by major payor category, of the following:
  - a. Gross charges
  - b. Contractual adjustments and other contra-revenue adjustments
  - c. Net revenue
5. Underlying data for the referral and visit volume comments included in the press release and the earnings conference call. In order to better understand this, we would propose the following:
  - a. A year-over-year analysis of the following key metrics for the period 7/1/01 - 10/31/01 compared to 7/1/02 - 10/31/02:
    - i. Changes in visits per discharge
    - ii. Same store visit volume
    - iii. Trend in admissions

In addition, the HealthSouth IT group has created an Oracle database for the period January 2002 through June 2002. We suggest that this database be updated with patient billing data for the period July 1, 2002 thru October 31, 2002 and July 1, 2001 thru October 31, 2001 to facilitate the above-mentioned analyses. The database should include all existing data structures, existing data fields and include two new data fields (1): Admission date, and (2) Discharge date.

Please call me at (240) 460-3452 to discuss our request.

CC: Hal Hirsch, Esq., Fulbright & Jaworski LLP  
Thomas Dowdell, Esq., Fulbright & Jaworski LLP  
Dominic DiNapoli, FTI Consulting  
Debbie Smith, FTI Consulting

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HealthSouth Corp.

HHEC 44-1120

**CONFIDENTIAL  
TREATMENT REQUESTED  
HEALTHSOUTH Corporation  
MEETING OF THE AUDIT COMMITTEE  
OF THE BOARD OF DIRECTORS  
NOVEMBER 13, 2002**

**MINUTES**

Tab 41

A Meeting of the Audit Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room of the Corporation's offices in Birmingham, Alabama on November 13, 2002.

The following members were present: George H. Strong, Chairman, C. Sage Givens and Larry D. Striplin, Jr. The following guests were also present: Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Jason M. Brown, Vice President — Finance of the Corporation, Emery W. Harris, Group Vice President — Finance and Assistant Controller of the Corporation, and James Lamphron, Wayne Dunn and Mike Mills of Ernst & Young LLP.

Mr. Strong acted as Chairman of the Meeting and Mr. Hale acted as Secretary.

The Meeting was called to order by Mr. Strong at 8:10 a.m. C.S.T.

**Ernst & Young Report**

Mr. Strong requested an explanation from Ernst & Young as to why third quarter earnings changed from \$.12 as reported during the Audit Committee conference call to a final number of \$.10 for the quarter.

**HHEC 18-01801**

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Mr. Lamphron explained that the reduction in earnings from \$.12 to \$.10 was due to an error that was made in management's calculation of FIN 44 charges. Members of the Audit Committee were made aware of the change via telephone and prior to the earnings release.

Mr. Lamphron and Mr. Dunn provided to the Committee a review of the 2002 Audit Plan (copy attached). Mr. Lamphron discussed the audit process and key industry issues, and Mr. Dunn reviewed the audit planning process and audit scope. Also discussed with the Committee were the audit planning timetable, the Ernst & Young team, independence letter and quality control. Mr. Lamphron stated that audit fees would be provided at a later date, but added that this year's audit would be more complex and take more time due to NYSE rule changes and HEALTHSOUTH issues, resulting in higher fees than in prior years.

**Other Matters**

Mr. Strong requested that Mr. McVay provide to the Audit Committee a fact sheet on Source Medical for the Committee's review and use in providing additional information to the Board on Source Medical. Mr. Strong also requested that the Committee be provided with the results of investments from the Investment Department and a detailed review of all related party transactions.

Also discussed was the need for either the Audit Committee or the Compliance Committee to review procedures for reporting related party transactions.

The Committee reviewed the nature of pristine audit services provided by Ernst & Young. The Ernst & Young representatives confirmed that these services do not constitute prohibited non-audit services. The Committee and the Ernst & Young representatives also discussed necessary revisions to the Audit Committee Charter in light of the Sarbanes-Oxley Act, the new SEC regulations and proposed new NYSE requirements.

Mr. Smith presented a report of activities of the Internal Audit Department. He noted that the HCAR program has increased audit volumes in the outpatient division.

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The Committee then met with Mr. Smith and the representatives of Ernst & Young without management present.

There being no further business to transact, the Meeting was adjourned.

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Brandon O. Hale  
Secretary

---

George H. Strong  
Chairman

HS-72123.1

**HEALTHSOUTH.**  
One HEALTHSOUTH Parkway  
Birmingham, AL 35243

MEMORANDUM

Tab 42

TO: C. Sage Givens  
FROM: Brandon O. Hale *BoH*  
DATE: February 28, 2003  
SUBJECT: Board Minutes

*CSC by phone  
NO*

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Enclosed please find revised Board Minutes for August 26, 2002, August 30, 2002, September 24, 2002, October 1, 2002, and October 15, 2002. I have also enclosed drafts of Minutes for the December 12, 2002, December 17, 2002, January 6, 2003 (a.m.) and January 6, 2003 (p.m.) meetings. Please review and we will discuss and finalize at the Board Meeting in Orlando.

You should receive another package from me on Tuesday with additional Minutes for your review.

Enclosure

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SG 0001182

HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
AUGUST 26, 2002  
MINUTES

*By phone*

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated August 26, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, William T. Owens, President and Chief Operating Officer of the Corporation, Joel C. Gordon, Phillip C. Watkins, M.D., Larry D. Striplin, Jr., George H. Strong, John S. Chamberlin and C. Sage Givens. The following guests were also present: Brandon O. Hale, Executive Vice President - Administration and Secretary, Malcolm E. McVay, Executive Vice President and Treasurer of the Corporation, Weston L. Smith, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, and Larry D. Taylor, President and Chief Operating Officer - Ambulatory Services of the Corporation, William McGahan, Rod O'Neill, Hugh O'Hare, Scott Wollard, John Wagner and Rick Leaman of UBS Warburg, LLC, and Samuel H. McGarr and Tom Avent of KPMG. Messrs. Chamberlin, Strong and Leaman, as well as Ms. Givens, participated in the Meeting via a telephonic connection whereby everyone could freely hear and speak to one another. All other Directors and guests were physically present.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 4:00 p.m. C.D.T.

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SG 0001183

## Project Crimson Strategic Alternatives Discussion

UBS Warburg Presentation

Mr. Scrusby asked Mr. McGahan and his associates to lead the Board through a strategic alternative discussion on Project Crimson. UBS Warburg began with a review of a segment valuation and a discussion of ways to improve business focus by considering several alternatives, including the sale of the diagnostic facilities combined with the split off of the surgery centers, the sale of the surgery centers, the spin-off or split-off of the surgery centers (with or without IPO) and the sale of the diagnostic facilities. UBS Warburg then presented to the Board a debt analysis and discussed how the current debt profile impacted the alternatives being considered. In closing, Mr. McGahan and the UBS Warburg team presented a summary of the timeline of events to take place and led a discussion of the key separation decisions that needed to be made by the Corporation.

KPMG Opinion

Mr. Scrusby requested Mr. McGarr and Mr. Avent give their opinion on whether there is a justifiable business reason for either the spin off or split-off of the surgery division, thus allowing a tax-free transaction. Mr. Avent responded that he is very comfortable that there are several justifiable business reasons for the spin-off or split-off transaction which would allow a tax-free transaction to be effected.

CMS Transmittal 1753

*much too much*

Mr. Scrusby asked Mr. Owens to review with the Board the timeline of events resulting from CMS Transmittal 1753. Mr. Owens stated that CMS Transmittal 1753 was posted to Part B carriers only on May 17, 2002 and the Corporation received a copy of the Transmittal from a third party in early June. The Corporation forwarded a copy to Blue Cross of Alabama (the Corporation's fiscal intermediary), who advised the Corporation that the Transmittal did not apply to HEALTHSOUTH. The Corporation requested a formal letter from Blue Cross of Alabama. After not having received one, a meeting was scheduled for July 18, 2002 with CMS and reimbursement representatives from HEALTHSOUTH. That meeting generated more questions than answers. Mr. Owens stated that he had believed the Transmittal might apply to the Corporation's outpatient services in freestanding

- 2 -

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SG 0001184

outpatient centers. He informed Mr. Scrushy on August 6 that it might apply to such services in freestanding outpatient centers and the impact could be \$15,000,000 - \$20,000,000. Mr. Scrushy stated that he had advised Mr. McVay and subsequently Mr. Owens to go back to CMS for better clarification. The meeting on August 15 did not answer all questions regarding Transmittal 1753, but answered enough questions to allow the Corporation to prepare an analysis of the potential impact.

Mr. Owens advised the Board that he was comfortable with the chronology of events and that the Corporation had been working diligently since the August 15 meeting to assess the impact of the Medicare changes.

Mr. Scrushy and Mr. Owens advised the Board that the estimated impact on revenue of CMS Transmittal 1753 would be \$175,000,000 per year, and that the Corporation would be putting out a press release disclosing this on Tuesday, August 27.

#### SCA Update

Mr. Taylor thanked Messrs. Scrushy and Owens and the Board for their support and made comments regarding SCA's management team and updated the Board on current initiatives and development activities.

All guests left the room at this time for the Board to continue discussions regarding Project Crimson and CMS Transmittal 1753. After discussions, the Board, upon motion duly made and seconded, gave preliminary approval to management to proceed with development of a plan for a separation transaction involving the surgery center division. There were no votes cast against the motion, with Mr. Gordon not voting. It was noted that the promotions and responsibility changes involving Mr. Owens, Mr. Smith and Mr. McVay that were approved at the August 8 meeting would become effective as of this meeting.

#### Other Business

Mr. Gordon presented the recommendation of the Compliance Committee that the limitation on gifts in the Corporation's Standards of Business Conduct be revised to reflect a \$300 annual

limitation and to eliminate the per-gift limitation. After discussion, upon motion duly made and seconded, the Board unanimously approved this change.

There being no further business to transact, the Meeting was adjourned.

  
\_\_\_\_\_  
Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

\_\_\_\_\_  
Richard M. Scrusby  
Chairman of the Board

HEALTHSOUTH Corporation

WAIVER OF NOTICE

We, the undersigned, constituting all the members of the Board of Directors of HEALTHSOUTH Corporation, a Delaware corporation, do hereby waive notice of the time, place and purpose of the Meeting of the Board of Directors of HEALTHSOUTH Corporation to be held on August 26, 2002, at 4:00 p.m. C.D.T., and we consent to the transaction of such business as may properly become before said Meeting.

DATED the 26th day of August, 2002.

\_\_\_\_\_  
Richard M. Scrushy

\_\_\_\_\_  
Phillip C. Watkins

\_\_\_\_\_  
C. Sage Givens

\_\_\_\_\_  
Joel C. Gordon

\_\_\_\_\_  
Charles W. Newhall, III

\_\_\_\_\_  
Larry D. Striplin, Jr.

\_\_\_\_\_  
John S. Chamberlin

\_\_\_\_\_  
William T. Owens

\_\_\_\_\_  
George H. Strong

HS-71307.1

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TREATMENT REQUESTED

SG 0001187

**CONFIDENTIAL  
TREATMENT REQUESTED  
HEALTHSOUTH Corporation**

**MEETING OF THE COMPENSATION COMMITTEE  
OF THE BOARD OF DIRECTORS**

JANUARY 25, 2001

MINUTES

Tab 43

A Meeting of the Compensation Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room of the Corporation's offices in Birmingham, Alabama on January 25, 2001.

The following members were present: Larry D. Striplin, Chairman and John S. Chamberlin. The following guests were also present: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, William T. Owens, Executive Vice President and Chief Financial Officer of the Corporation, and Brandon O. Hale, Senior Vice President – Administration and Secretary of the Corporation. Messrs. Chamberlin and Hale participated in the Meeting via a telephonic conference call connection whereby everyone could freely hear and speak to one another.

Mr. Striplin acted as Chairman of the Meeting and Mr. Hale acted as Secretary. The Meeting was called to order by Mr. Striplin at 11:05 a.m. CST.

Mr. Scrusby provided to the Committee members for their review a list of compensation recommendations for the executive officers. Thereafter, Messrs. Scrusby and Hale left the room.

The Committee deliberated and subsequently advised Mr. Hale that they had approved the following salaries for executive officers for the year ending December 31, 2001:

Richard M. Scrusby	\$1,500,000
William T. Owens	500,000
Larry D. Taylor	450,000
Robert E. Thomson	450,000

**HHEC 18-01806**

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Patrick A. Foster	450,000
Thomas W. Carman	360,000
Weston L. Smith	275,000
William W. Horton	300,000
Brandon O. Hale	235,000
Malcolm E. McVay	220,000

The Committee further advised Mr. Hale that it had made certain stock option grants on January 4.

There being no further business to transact, the Meeting was adjourned.

---

Brandon O. Hale  
Secretary

---

Larry D. Striplin, Jr.  
Chairman

JAN. 29. 2003 5:40PM

MEDISTAR 7132662866

NO. 457 P. 2/36



Subcontract Agreement

Tab 44

Subcontract No. 011218-18

Cost Code: 08.M.089000-S

CONTRACTOR: BRASFIELD & GORRIE, L.L.C. ("Contractor")  
110 Riverpoint Corporate Center Dr  
Bham, AL 35243  
 Phone: 205-967-0118 Fax: 205-262-0285

SUBCONTRACTOR: Nelson-Brantley Glass Contractors, Inc. ("Subcontractor")  
Attn: David Pritchard  
2924 3rd Ave. South, Birmingham, AL 35233  
 Phone: 205-328-2172 Fax: 205-328-4240  
 Email: \_\_\_\_\_  
 (Please include street address)

WORK: Exterior Glass System ("Work")  
Lump Sum / Guaranteed Maximum Price  
 (general description only)

PROJECT: Healthsouth Medical Center ("Project")  
110 Riverpoint Corporate Center Dr.  
Birmingham, AL 35243

OWNER: HEALTHSOUTH CORPORATION ("Owner")  
One HEALTHSOUTH Parkway  
Birmingham, AL 35243

ARCHITECT-ENGINEER: CLA ARCHITECTURE ("Architect")  
504 Brookwood Blvd.  
Homewood, AL 35209

**HHEC 412-0020**  
 Confidential Treatment  
 Requested by HealthSouth Corp.

PRIME CONTRACT: dated September 11, 2001 ("Contract")

SUBCONTRACT PRICE: Five Million, Six Hundred Twenty-Eight Thousand, Nine Hundred Sixty-Three & Two Cents  
7 (\$ 5,628,963.00 ) Dollars ("Price")

MONTHLY BILLING DATE: 3<sup>rd</sup> and 18<sup>th</sup> of each month ("Monthly Billing Date")

MONTHLY BILLING MAILED TO: Brasfield & Gorrie (Attn: Jason Head)

( 1 Original 1 Copies)

110 Riverpoint Corporate Center Dr.  
Birmingham, Al. 35243

RETAINED PERCENTAGE: Two and one half ( 2.5 %) ("Retained Percentage")

PAYMENT AND PERFORMANCE BONDS: Required  Not Required

(The above terms are incorporated by reference and are more fully explained below.)

On this the 30 day of July 2002, Contractor and Subcontractor, with offices at the addresses shown above, agree for themselves, their successors and assigns as follows:

10/98

1

**HHEC 412-0021**  
Confidential Treatment  
Requested by HealthSouth Corp.

**UNANIMOUS WRITTEN CONSENT  
IN LIEU OF MEETING OF THE  
BOARD OF DIRECTORS OF  
HEALTHSOUTH Corporation**

FEBRUARY 4, 2002

Tab 45

Pursuant to Section 141(f) of the General Corporation Law of the State of Delaware, the undersigned, being all of the members of the Board of Directors of HEALTHSOUTH Corporation, a Delaware corporation (the "Corporation"), do hereby (i) consent to and adopt the following resolutions as of the date hereof, which resolutions shall have the same force and effect as if adopted by an affirmative vote at a meeting of the Board of Directors duly called and held; (ii) waive all requirements of notice; and (iii) direct that this written consent be filed with the minutes of the proceedings of the Corporation:

RESOLVED, that the following persons are hereby awarded options under the Corporation's 1993 Consultants' Stock Option Plan to purchase that number of shares set forth following their names below, such options to have an exercise price of \$10.90 per share, being the fair market value of the Corporation's Common Stock on the date of grant:

<u>Name</u>	<u>Number of Shares</u>
Thomas D. Mottola	250,000
Eric R. Hanson	20,000
Joel Katz	10,000
Swaid N. Swaid, M.D.	50,000

RESOLVED, that the options granted to Thomas D. Mottola are immediately vested and exercisable as of the date of grant.

RESOLVED, that the options granted to all other persons indicated above shall vest at the rate of 25% per year, commencing on February 4, 2003.

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TREATMENT REQUESTED

LS 0000236

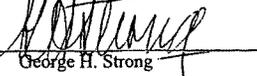
IN WITNESS WHEREOF, the undersigned, being all of the members of the Board of Directors of the Corporation, have executed this Consent as of the day and year first above written.

  
Richard M. Scrusby

  
C. Page Givens

  
Charles W. Newhall, III

  
John S. Chamberlin

  
George H. Strong

  
Phillip C. Watkins

  
Joel C. Gordon

  
Larry D. Stripling, Jr.

  
William T. Owens



## MEMORANDUM

To: Monzer Hourani  
From: Jim Collier *cc*  
Date: February 6, 2002  
Re: Glass

---

Monzer,

During the recent weeks of intense study of the designs of the hospital's exterior and an analysis of various glazing contractors, Nel Bran (Nelson Brantley Glass Contractors) has emerged as one of the premier contractors in this area in this part of Alabama. As you know, the building's glazing system and its installation on this project are very important and not uncomplicated. We will have what will probably be one of the largest glazing projects in the Southeast.

It is important that the subcontractor for this portion of the work be one of the best qualified, have the best technicians, and be able to display a track record of quality and capability. Thus far, of the multiple subcontractors identified, Nel Bran is the ranking firm.

This makes things complicated. Larry Striplin, Chairman of Nel Bran, is also a member of the Board of HealthSouth.

I want to avoid any hint of impropriety in our selection of this or any other subcontractor as this project moves forward. This building is not a governmental facility; therefore, we are not obligated to take the lowest bid at bid date, but I feel we have an obligation to our client, HealthSouth, to take the best bid.

This memo is my yellow flag reminder that the entire team all be cognizant of the potential for suggestions of impropriety and be very careful to ensure that our work and negotiations with these and all other subcontractors are "open book" and straightforward.

Thank you,  
Jim Collier

## MEDISTAR CORPORATION

Medical Real Estate Development

504 Brookwood Boulevard • Birmingham, Alabama 35209 • (205) 970-2288 • FAX (205) 970-0990

**HHEC 412-0078**  
Confidential Treatment  
Requested by HealthSouth Corp.



MEMORANDUM

Tab 47

To: Monzer Hourani

From: Jim Collier *JC*

Date: April 12, 2002

Re: Nelson Brantley Glass Contractors

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Monzer,

Attached is my copy of the recent letter from Jack Darnall documenting Brasfield and Gorrie's and CLA's thinking and recommendations regarding the use of Nel-Bran as the glass subcontractor for the Hospital project.

I would totally agree with Jack's assessment of the team's recommendation of Nel-Bran. It is in the best interest of the project's budget and schedule to move ahead with their selection as a partner to work with.

Please bear in mind that we will still take competitive bids for this package of work when the construction documents are completed.

I continue to urge that we all use the utmost in care to avoid any hint of favoritism being exercised in this selection.

Thank you,  
Jim

**HHEC 412-0079**  
Confidential Treatment  
Requested by HealthSouth Corp.

MEDISTAR CORPORATION

Medical Real Estate Development

504 Brookwood Boulevard • Birmingham, Alabama 35209 • (205) 970-2288 • FAX (205) 970-0990

*Morgan Glass Issue*  
*w/ Judge —*  
*January '03*

April 8, 2002

Mr. Monzer Hourani  
 Medistar  
 7670 Woodway, Suite 160  
 Houston, TX 77063

Re: **HEALTHSOUTH Medical Center**  
**Birmingham, Alabama**  
**Glass Subcontractor**

Dear Monzer:

Both internally and with our design partner, CLA, we have discussed at length the need and timeliness of hiring a glass subcontractor on a negotiated basis. In order for Brasfield & Gorrie to commit to delivering this building in June 2004, we need to move in this direction as both the design and construction team feel we need the services that a sub has to offer. There are several reasons for this:

- 1.) Submittal process needs to begin immediately. The submittal process is critical to the design team to help finalize construction document details that are a critical part of the weatherproof design. The project team will benefit from this input.
- 2.) Mock-up Construction has begun, we need to work with the subcontractor who is performing this in order to flush out construction details and we do not need to lose those involved who are already down the learning curve path.
- 3.) Project phasing and scheduling considerations. The curtainwall is a major component of the project schedule. If the project schedule is to be met, we need the services of a glass subcontractor partner to help us trim time out of the schedule as well as maintain the current crunch schedule we are working towards.
- 4.) By having a subcontractor partner on board, we can finalize the integral details of both the design and construction schedule and allow others to focus on other critical areas of the building.
- 5.) Our original schedule required us to have a curtainwall sub on board by April 1 with a design package in hand. Major scope additions to the project have pushed the glass package out but the need for having a sub on board is even greater.

Brasfield & Gorrie whole-heartedly endorses hiring Nelson Brantley as our glass subcontractor partner to work with us to help achieve the schedule, budget, and quality goals and set forth by HEALTHSOUTH and Medistar. Brasfield & Gorrie will work diligently with Nelson Brantley to negotiate a fair and competitive contract that allows Nelson Brantley to continue work yet ensures

HEALTHSOUTH a competitive price that complies with the parameters surrounding this job. The benefits of working with Nelson Brantley as opposed to other qualified subs are as follows:

1. The Nelson Brantley "team" understands the project schedule and are actively working with us to reduce the overall durations. This is critical in allowing us to commit to the accelerated project schedule.
2. The Nelson Brantley "team" clearly understands the project budget and its constraints.
3. The Nelson Brantley "team" clearly understands the look and design feel that this client desires and can help the project team work towards that design to assure that nothing is compromised in the way of aesthetics.
4. Nelson Brantley is Alabama based.
5. The Nelson Brantley "team" uniquely understands HEALTHSOUTH's goals with this project. Having a subcontractor team member who understands and embraces "the dream and the vision" is both a necessity and a benefit based upon their commitment to the same goals as all of us currently on the team. This would certainly not just be "another job" as we would encounter with any other company.
6. Most importantly, Brasfield & Gorrie needs the services of someone who has the capability of making the schedule happen as it relates to the curtainwall and glass systems. In order for Brasfield & Gorrie to commit to the accelerated schedule, Nelson Brantley has committed to help us accelerate this portion. If the building is not dried-in, it puts even more of the finishes at risk by exposing them to the weather.

I realize that our approach and recommendation are different than the normal process but this has become an "unorthodox project" with regards to design packaging, information flow, and construction approach. It is in our appreciation for this and our desire to meet our mutual clients' needs that lead us to this position. Thank you for help in this matter.

Yours truly,

Jack Darnall  
Vice President  
Healthcare Division Manager

cc: Jim Collier  
Miles Creel  
Dan Luhrs  
Alan Anthony  
Steve Haney

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TREATMENT REQUESTED

HEALTHSOUTH Corporation

Meeting of the Corporate Compensation Committee

April 29, 2002

Minutes

Tab 48

A Meeting of the Compensation Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held at the Corporation's offices in Birmingham, Alabama on April 29, 2002.

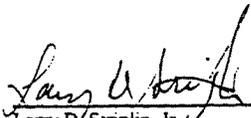
The following members were present: Larry D. Striplin, Jr., Phillip C. Watkins, M.D., and John S. Chamberlin. The following guests were also present: William T. Owens, President and Chief Operating Officer of the Corporation and Brandon O. Hale, Senior Vice President, Administration and Secretary of the Corporation. Messrs. Owens and Hale were present at the Corporation's offices and all others participated via a telephonic connection.

Mr. Striplin acted as Chairman and Mr. Hale acted as Secretary. The Meeting was called to order by Mr. Striplin at 11:00 AM CDT.

Members of the Committee had been provided with Management's recommendation for bonuses to be awarded to the Corporation's Executive Officers. (Copy attached to these minutes) Mr. Striplin asked if Committee Members had reviewed the list and asked for discussion. Mr. Chamberlin made a Motion to approve as submitted and Dr. Watkins seconded the Motion. The Motion was approved unanimously by the Committee.

Mr. Owens advised the Committee that the Company had exhausted its efforts to find a way to extend Mr. Scrusby's options which expire in May 2002. Mr. Owens stated that there were no good choices to consider and Mr. Scrusby may have to sell shares in the market.

There being no further business to transact, the Meeting was adjourned.

  
\_\_\_\_\_  
Larry D. Striplin, Jr.  
Chairman, Compensation Committee  
of the Board of Directors

  
\_\_\_\_\_  
Brandon O. Hale  
Senior Vice President, Administration  
and Secretary

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TREATMENT REQUESTED

Name	Social Security Number	Title	Digiparis Int Profit	Previous Pay	Current Pay	Merit Increase	%	2001 Bonus	2002 Bonus
Scrushy, Richard M.	421-92-9616	President & COO HSC & Dr	90000000C	500,000.00	800,000.00	300,000.00	60.00%	\$6,500,000.00	10,000,000.00
Owens William T.	135-56-3483	President & COO	94100100C	450,000.00	490,000.00	40,000.00	8.89%	\$1,500,000.00	2,000,000.00
Taylor, Gary D.	419-60-4102	President & COO	94300100C	450,000.00	490,000.00	40,000.00	8.89%	\$500,000.00	600,000.00
Foster, Patrick	056-38-8771	EVP Corp Development	91000000C	360,000.00	390,000.00	30,000.00	8.33%	\$75,000.00	250,000.00
Carrigan, Thomas W	416-64-8836	EVP CFO	90000000C	300,000.00	325,000.00	25,000.00	8.33%	\$100,000.00	400,000.00
Smith, Weston L	423-82-7827	EVP & Treasurer	90200000C	260,000.00	280,000.00	20,000.00	7.69%	\$100,000.00	175,000.00
McVay Malcolm E.	422-66-8485	SVP Administration	90500000C	200,000.00	320,000.00	30,000.00	10.34%	\$75,000.00	100,000.00
Hale Brandon Q.	420-08-1211	SVP Finance - Reimbursement	98400000C	200,000.00	215,000.00	15,000.00	7.50%	\$60,000.00	125,000.00
Jones, Susan M.	419-74-5437	EVP & Corporate Counsel	92000000C	300,000.00	350,000.00	30,000.00	10.00%	\$100,000.00	150,000.00



FAX Cover Sheet

Tab 49

TO: MONZER HOVRANI FROM: BRASFIELD & GORRIE  
 COMPANY: HEALTHSOUTH MEDICAL CENTER PHONE NUMBER: 205-328-4000  
 FAX NUMBER: 205-458-0155  
 FAX NUMBER: PAGES: 2 (INCLUDING COVER)  
 PHONE NUMBER: DATE: 05/08/2002  
 RE: GLASS PRICING CC:

URGENT  FOR REVIEW  PLEASE COMMENT  PLEASE REPLY  PLEASE RECYCLE

Note:

Dear Monzer,

Attached are the glass proposal prices that are based upon the Volume <sup>THREE</sup> ~~Four~~ Exterior Skin Drawings which are considered design development documents.

We have scoped the four proposals to ensure an equitable comparison. Please review this and let me know what direction we need to pursue. We would like to move towards making an award Monday, May 13<sup>th</sup>.

NelBran has presented us with a pre-construction services price of \$50,000 that they expect in the event they are not awarded the project; this is included in the attached analysis. Please do not hesitate to call when you are ready to discuss this.

Yours truly,

Jack Darnall  
 Vice President  
 Healthcare Division Manager

If you did not receive all of the pages or find that they are illegible, please

CONFIDENTIALITY NOTE:

The following facsimile is intended to whom it is addressed and may contain otherwise exempt from disclosure under applicable law. If the reader of this employee or agent responsible for delivering the message to the intended recipient dissemination, distribution, or copying of this communication is strictly prohibited in error, please immediately notify us by telephone and return the original to Postal Service. Thank you.

Brasfield & Gorrie, L.L.C. • Health  
 729 South 30<sup>th</sup> Street • Birmingham, AL  
 P. O. Box 10383 • Birmingham, AL  
 Phone: 205-328-4000 • Fax: 205-458-0155

2<sup>ND</sup> ROUND GLASS PRICING  
 SPENT BID EVALUATION SHEET  
 TO MONZER  
 REC'D REV'D PRICE FROM  
 NEL-BRAN

INSTRUCTED BY MEDISTAR TO AWARDED TO NEL-BRAN

HHEC 412-0139  
 Confidential Treatment  
 Requested by HealthSouth Corp.

	<u>JAMCO</u>	<u>JUBA</u>	<u>Gardner</u>	<u>Nel Bran</u>
<b>Scoped Budget Total</b>	\$5,464,964	\$5,739,844	\$5,918,250	\$6,269,468
<b>Glass Mfg</b>	Viracon	Viracon	Viracon	Viracon
<b>Metal System Mfg</b>	Jamco 2000	Vistawall	GMS 200	Texaswall

HHEC 412-0140  
Confidential Treatment  
Requested by HealthSouth Corp.

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HEALTHSOUTH Corporation

Meeting of the Corporate Compensation Committee

July 25, 2002

Minutes

Tab 50

A Meeting of the Compensation Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held at the Corporation's offices in Birmingham, Alabama on July 25, 2002.

The following members were present: Larry D. Striplin, Jr., Phillip C. Watkins, M.D., and John S. Chamberlin. The following guests were also present: Brandon O. Hale, Executive Vice President, Administration and Secretary of the Corporation and William W. Horton, Executive Vice President and Corporate Counsel of the Corporation. Messrs. Hale and Horton were present in the Corporate office and all others participated via a telephonic connection.

Mr. Striplin acted as Chairman of the Meeting and Mr. Hale acted as Secretary.

Mr. Striplin called the meeting to order at 9:03 AM CDT.

The purpose of the Meeting was for the Compensation Committee of the Board of Directors to consider Mr. Scrusby's request to repay the principal amount of his loan under the 1999 Executive Equity Loan Plan by transferring to the Company HEALTHSOUTH shares with a value equal to the principal amount. The accrued interest on the loan was paid in cash by Mr. Scrusby in June 2002.

Mr. Horton advised the Compensation Committee that Mr. Scrusby's request to repay the principal amount of his loan with this transaction would require the Committee's ratification. Mr. Horton further advised the Committee that the transaction would accomplish three significant things. It would satisfy Mr. Scrusby's loan and eliminate the last significant loan under the 1999 Plan to an executive officer, it would allow the Company to acquire over two million shares as a part of the buyback effort without any additional cash outlay and it would likely reduce the depressive effect that would result if Mr. Scrusby sold shares for cash in a down market.

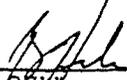
The Committee members agreed that the repayment of Mr. Scrusby's loan would be a positive event and that they should consider approval to repay the loan by transfer of stock back to the Company in an amount equal to the principal amount. After discussion among the Committee Members and Mr. Horton regarding the effective date of the transfer of shares back

HHEC 18-01841

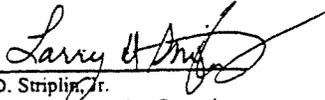
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TREATMENT REQUESTED

to the Company and the method for determining the share price for the transfer the Committee decided not to act upon the request until Mr. Striplin had an opportunity to discuss these issues with Mr. Scrushy. The Committee agreed to reconvene at a later date.



Brandon O. Hoke  
Executive Vice President, Administration  
and Secretary



Larry D. Striplin, Jr.  
Chairman, Compensation Committee  
of the Board of Directors



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HEALTHSOUTH Corporation

Meeting of the Corporate Compensation Committee

July 31, 2002

Minutes

Tab 52

A Meeting of the Compensation Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held at the Corporation's offices in Birmingham, Alabama on July 31, 2002.

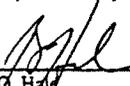
The following members were present: Larry D. Striplin, Jr., Phillip C. Watkins, M.D., and John S. Chamberlin. The following guests were also present: Brandon O. Hale, Executive Vice President, Administration and Secretary of the Corporation and William W. Horton, Executive Vice President and Corporate Counsel. Messrs. Hale and Horton were present in the Corporate office and all others participated via a telephonic connection.

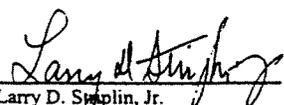
Mr. Striplin served as Chairman of the Meeting and Mr. Hale served as Secretary.

Mr. Striplin called the Meeting to order at 2:00 PM CDT.

The purpose of this Meeting was to further consider Mr. Scrushy's request to repay the principal amount of his loan under the 1999 Executive Loan Plan by transferring to the Company HEALTHSOUTH shares with a value equal to the principal amount.

After reviewing the discussion at the July 25 meeting and having further discussion, Committee members agreed to approve the repurchase of shares from Mr. Scrushy to repay the principal of his loan effective July 31, 2002 at a share price established by using an average between the high and low trade price on July 31, 2002.

  
\_\_\_\_\_  
Brandon O. Hale  
Executive Vice President, Administration  
and Secretary

  
\_\_\_\_\_  
Larry D. Striplin, Jr.  
Chairman, Compensation Committee  
of the Board of Directors

CONFIDENTIAL  
TREATMENT REQUESTED  
HEALTHSOUTH Corporation

Meeting of the Corporate Compensation Committee

September 2, 2002

Minutes

Tab 53

A Meeting of the Compensation Committee of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held at the Corporation's offices in Birmingham, Alabama on September 2, 2002.

The following members were present: Larry D. Striplin, Jr., Phillip C. Watkins, M.D., and John S. Chamberlin. The following guest was present: Brandon O. Hale, Executive Vice President, Administration and Secretary of the Corporation.

Mr. Hale was advised by Mr. Striplin that he discussed via telephone the following salary changes for Mr. Scrushy and Mr. Owens. Mr. Striplin stated that the changes were approved unanimously by the Committee to be effective September 2, 2002.

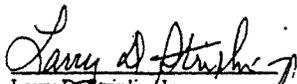
Richard M. Scrushy, Chairman of the Board

Salary \$1,200,000/year  
Target Bonus \$1,200,000/year

William T. Owens, Chief Executive Officer

Salary \$1,200,000/year  
Target Bonus \$ 600,000/year

  
\_\_\_\_\_  
Brandon O. Hale  
Executive Vice President, Administration  
and Secretary

  
\_\_\_\_\_  
Larry D. Striplin, Jr.  
Chairman, Compensation Committee  
of the Board of Directors

**MERCER**

Human Resource Consulting

February 26, 2003

**Officer Compensation and Stock  
Grant Summaries**

**HealthSouth Corporation**

**Steve Harris**  
Atlanta, GA

**David Jones**  
Atlanta, GA



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LS 0000445

Richard Scrushy  
 Chairman and CEO  
 Current Salary - \$1,500,000  
 2001 Monthly Bonus - \$2,400,000  
 May 2002 Bonus - \$10,000,000  
 Voluntarily suspended salary and bonus as of October 2002

Grant Date	Number Of Options	Strike Price	Face Value	Exercise Date	Options Exercised	Price	Gain	Notes
October-98	2,250	\$10.0000	\$22,500					Immediate vesting
October-98	119,750	\$10.0000	\$1,197,500					Immediate vesting
October-98	1,000,000	\$10.0000	\$10,000,000					Immediate vesting
October-98	378,000	\$10.0000	\$3,780,000					Immediate vesting
March-99	850,000	\$11.0000	\$9,350,000					Immediate vesting
December-99	200,000	\$4.9375	\$987,500					Immediate vesting
February-00	800,000	\$4.8750	\$3,900,000					Immediate vesting
January-01	1,000,000	\$13.8750	\$13,875,000					Immediate vesting
November-01	200,000	\$11.9900	\$2,398,000					Immediate vesting
February-02	1,000,000	\$10.9000	\$10,900,000					Immediate vesting
<b>Total</b>	<b>5,550,000</b>		<b>\$56,410,500</b>	<b>Total</b>	<b>0</b>		<b>\$0</b>	
<b>Average</b>	<b>1,110,000</b>		<b>\$11,282,100</b>					

Grant Date	Number of Full Value Shares	Strike Price	Face Value
May-99	100,000	\$13.313	\$1,331,250

Mercer Human Resource Consulting

**(H) HEALTHSOUTH.**

**FAX TRANSMITTAL SHEET**

**TO:** Phillip C Watkins, MD

**FROM:** Anthony J Tanner  
Executive Vice President

Tab 55

**DATE:** 30-Sep-99

**FAX NUMBER:**

**TOTAL # OF PAGES:** 2 (including cover sheet)

**COMMENTS:**

Phil -

Here is the letter that I spoke to you about. If you have any changes, please make them and then fax the corrected copy to me at 850-927-4031. I will then prepare a corrected version for our signatures. If you have any questions, call Kathee Parks at 969-5646 and she will be able to reach me.

Thanks,

Revised copy.  
Original will be sent  
by courier for your  
signature

If there are problems receiving this transmittal please call:

**(205) 969-4717**

ONE HEALTHSOUTH PARKWAY • BIRMINGHAM, ALABAMA 35243

September 30, 1999

Richard M Scrushy  
Chairman & CEO  
HEALTHSOUTH Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

We have come under increasing pressure from our shareholders to change the mix of the Board. With the management restructuring that is taking place, we feel that this is an opportune time to make changes.

The Corporation has also been criticized by institutional shareholders for the lack of female and minority representation on the Board. Since 1985, Sage has been our sole female director and the majority of investors do not realize that she is female. The Board should consider the election of another qualified woman to serve as an outside director.

In addition, we have come under criticism about the number of inside directors that are on the Board. Many institutional investors feel that there should only be a minimum number of inside directors on a board. Our current complement of five inside directors is quite high in comparison to the majority of public companies. In addition, we are sending mixed signals to our employees and shareholders by having both a division president and the corporation's president on the board. We recommend that Daryl step down from the Board leaving four inside directors.

With these two actions, the Board can change from the current 5:7 inside to outside director ratio to a 4:8 ratio which should be more acceptable to our shareholders.

We recommend that the Board consider these actions at the November meeting.

Sincerely,



Anthony J Tagner  
Executive Vice President, Secretary  
and Director

Phillip C Watkins, MD  
Director and Chairman, Audit  
& Compensation Committee

One HealthSouth Parkway • Birmingham, AL 35243  
205 967-7116  
<http://www.healthsouth.com>

Board Mix.doc



**HHEC 688-0039**  
Confidential Treatment  
Requested by HealthSouth Corp.

September 30, 1999

Richard M Scrushy  
Chairman & CEO  
HEALTHSOUTH Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

We have come under increasing pressure from our shareholders to change the mix of the Board. With the management restructuring that is taking place, we feel that this is an opportune time to make changes.

The Corporation has also been criticized by institutional shareholders for the lack of female and minority representation on the Board. Since 1985, Sage has been our sole female director and the majority of investors do not realize that she is female. The Board should consider the election of another qualified woman to serve as an outside director.

In addition, we have come under criticism about the number of inside directors that are on the Board. Many institutional investors feel that there should only be a minimum number of inside directors on a board. Our current complement of five inside directors is quite high in comparison to the majority of public companies. In addition, we are sending mixed signals to our employees and shareholders by having both a division president and the corporation's president on the board. We recommend that Daryl step down from the Board leaving four inside directors.

With these two actions, the Board can change from the current 5:7 inside to outside director ratio to a 4:8 ratio which should be more acceptable to our shareholders.

We recommend that the Board consider these actions at the November meeting.

Sincerely,



Anthony J Turner  
Executive Vice President, Secretary  
and Director



Phillip C Watkins, MD  
Director and Chairman, Audit  
& Compensation Committee

One HealthSouth Parkway • Birmingham, AL 35243  
205 967-7116  
<http://www.healthsouth.com>

board mix.doc



**HHEC 688-0040**  
Confidential Treatment  
Requested by HealthSouth Corp.

Appointment

Organiser: Esclavon, Mary  
Subject: Meeting with Dr. Watkins

Start Date: 08/20/2002 05/00 PM EST  
End Date: 08/20/2002 05/30 PM EST

Tab 56

Importance: Normal  
ReminderMinutesBeforeStart: 15

To go over Board issues and announcement.

Horton, Bill

---

From: phil390 [phil390@bellsouth.net] Tab 57  
 Sent: Friday, January 17, 2003 10:36 AM  
 To: Horton, Bill  
 Cc: Scrusby, Richard; Owens, Bill; 'cnewhall@nea.com'; Strong, George;  
 'jackchamberlin@healthsouth.com'; 'jcgordon@msn.com'; Hanson, Jon; 'ldsjr66@aol.com';  
 'sgivens@acaciavp.com'; 'rpmay@aol.com'; May, RP  
 Subject: Re: FW: Various Documents Attached

Bill,

I have reviewed the proposed changes on insider trading policy from the Corp Gov Com.

As you and I have discussed, the reduction of the window from 45 days to 30 days is overly restrictive and not consistent with what other companies do. Outside lawyers suggested that a 45 day window is "a middle of the road approach".

I see no reason to have such a short window that could be shortened further if an additional quiet period is declared.

The rest of the policy should be acceptable.

We can discuss further as a full board.

Phil Watkins

"Horton, Bill" wrote:

\*\*\*\*\*  
Warning: The attached file, hsCleanInsiderTradingPolicy.ZIP, was not scanned by  
\*\*\*\*\*

Attached below in a ZIP file is a transmittal from Bob May, containing a cover letter and comments on the Nominating/Governance Committee Charter and insider trading policy from the Corporate Governance Committee. These documents, including Bob's cover letter, are also being distributed to each of you by hand delivery or UPS Overnight on Friday morning. As you will see from Bob's memo, the Committee proposes to defer action on the Corporate Governance Guidelines, so there are no comments included on those.

I will be out of the office Friday, but if you cannot open this file and do not receive the overnight/hand

2/8/2003

**HHEC 355-0096**  
Confidential Treatment  
Requested by HealthSouth Corp.

delivery package, please send me an e-mail and I will try to arrange to get the documents to you in some other fashion.

Bill

William W. Horton  
Executive Vice President and Corporate Counsel  
HEALTHSOUTH Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243  
Telephone (205) 969-4977  
Facsimile (205) 969-4730  
bill.horton@healthsouth.com

-----Original Message-----

From: RPMAY@aol.com [mailto:RPMAY@aol.com]  
Sent: Thursday, January 16, 2003 4:21 PM  
To: Horton, Bill  
Subject: Various Documents Attached

Please distribute as outlined in cover letter thank you bob

Confidentiality Notice: This e-mail communication and any attachments may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

2/8/2003

**HHEC 355-0097**  
Confidential Treatment  
Requested by HealthSouth Corp.

## Unknown

From: phil390 [phil390@bellsouth.net]  
 Sent: Saturday, January 18, 2003 1:53 PM  
 To: Sage Givens; Chuck Newhall; Strong, George; Jack Chamberlin  
 Subject: Re: Delaware SLC case

Tab 58

I have made it a point keep on top of this by contacting our outside lawyers for updates.

I had read the plaintiffs brief about not staying the case because of Bob May's actions and others.

That is why I told you and George that I thought we would be ruled against. I asked for and received a copy of the judge's decision yesterday. It is pretty brutal to read.

We do not have a lead counsel on these cases. While I think Bill Horton is aware of all of what is happening,

he is not functioning as lead counsel either. As I said at dinner, while we have excellent attorneys working on all of

these cases I'm concerned about lack of coordination. We should be having a weekly conf call among all outside

counsel and Bill Horton. When I asked I was told this is not happening.

You heard Richard at dinner saying he was on top of things and not to worry about any of this. I am still concerned.

I also think we are going to have to insist on hearing and reading the full report from Bill Paul ( the former ABA

pres/Phillips Pet general counsel) about our legal dept. and his suggestions.

I don't anyone in house, management or board, has the knowledge to know what needs to be done to beef up

our legal dept. He is certainly an expert and we should listen carefully as a full board what he has to say.

I do think it *should* be brought up at the Tuesday conf call.

We need to keep dialog going among the long time board members.

HHEC 674-0047  
 Confidential Treatment  
 Requested by HealthSouth Corp

376

Regards, Phil

Sage Givens wrote:

Hi Phil, How are you privy to all of this information? I am glad that you are and that you are on top of it. I am increasingly concerned and would like to understand why our in house counsel is not coordinating ALL efforts regarding these suits. We need to act immediately. Is Bill Horton or Richard organizing a Board call to discuss this? Thanks, Sage

-----Original Message-----

From: phil390 [mailto:phil390@bellsouth.net]

Sent: Friday, January 17, 2003 7:34 PM

To: Jack Chamberlin; Sage Givens; Chuck Newhall; George Strong; Joel Gordon

Subject: Delaware SLC case

The Chancery Judge in Delaware has ruled against our SLC's request for a stay in the case.

He based the decision almost totally on the fact that the chairman of the SLC ( Bob May) was not acting independently in his public announcement that the Fullbright report vindicated Richard at a time when the SLC's own investigation was just getting underway.

He also questioned the independence of Hanson and Striplin in this case. He also ruled the present SLC will never be able to meet the independence burden as presently composed. There are 41 pages of negative comments in his decision.

We need the attorney's representing us to advise us urgently how to re-construct an SLC so as to not also hurt the Alabama case under Judge Horn.

The entire litigation problem with 21(?) law suites and 11 law firms working for us is mind boggling to say the least.

I would think the board should address this situation this week as we are all defendants.

HHEC 674-0048  
Confidential Treatment  
Requested by HealthSouth Cor

**Unknown**

**From:** Scrushy, Richard  
**Int:** Wednesday, February 05, 2003 10:24 AM  
**To:** phil390@bellsouth.net **Tab 59**  
**Subject:** Re: CONFIDENTIAL-- Documents Attached

Got to resign now so I can tell bod on friday. Also important to get settlement done. Rs

-----  
 Sent from my BlackBerry Wireless Handheld

-----Original Message-----  
 From: phil390 <phil390@bellsouth.net>  
 To: Horton, Bill <Bill.Horton@healthsouth.com>  
 CC: Scrushy, Richard <rscrushy@healthsouth.com>  
 Sent: Wed Feb 05 07:50:18 2003  
 Subject: Re: CONFIDENTIAL-- Documents Attached

If ok with Richard I would prefer to not announce until close of business Friday and let it sit over the weekend. I will email a nice note to the board when I get back Sunday evening. If anyone feels differently let me know. Leave a message on my cell, 862.5765 or in Utah at 435.645.8381

Regards, Phil W

"Horton, Bill" wrote:

Phil--

Attached are the documents you discussed with Richard. If you find them to be in order, please sign them and return them to me. Please let me know if you have questions. Thanks.

Bill

<<PCWResig.doc>> <<PCWConsAgmt.doc>>  
 Confidentiality Notice: This e-mail communication and any attachments may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

**From:** Horton, Bill  
**Sent:** Monday, March 10, 2003 12:12 AM **Tab 60**  
**To:** Hale, Brad  
**Subject:** FW: Board Meeting -- ATTORNEY-CLIENT PRIVILEGED AND CONFIDENTIAL

---

Any chance that this was dealt with in Orlando?

-----Original Message-----

**From:** Horton, Bill  
**Sent:** Tuesday, March 04, 2003 11:03 PM  
**To:** Scrushy, Richard  
**Subject:** FW: Board Meeting -- ATTORNEY-CLIENT PRIVILEGED AND CONFIDENTIAL

Richard, take a look at the e-mail below. I don't have any record that this has been done at any recent Board meeting. In order to avoid having to include in our 10-K the language that was in our third quarter 10-Q concerning the possible assertion of a default under our bond indentures, we need the Board to ratify the July transaction at a meeting this month. Once that is done, we can provide the fairness opinion and the certified resolutions to the trustee and clear this up. Please let me know if you have questions about this. Sorry to bother you, but this needs to be handled before we file the 10-K if at all possible.

-----Original Message-----

**From:** Horton, Bill  
**Sent:** Wednesday, December 11, 2002 2:14 PM  
**To:** Scrushy, Richard  
**Cc:** Hale, Brad  
**Subject:** Board Meeting -- ATTORNEY-CLIENT PRIVILEGED AND CONFIDENTIAL

I mentioned to you before the last BOD meeting that, in order to clean up the issue regarding the limitation on affiliate transactions in our bond indentures, we need the whole Board (with you abstaining) to ratify the Compensation Committee's approval of your loan repayment transaction in July. If that wasn't done at the last meeting, it should be done at this meeting so we can get certified resolutions to the trustee this month. Please call with any questions.

**(H) HEALTHSOUTH.**  
**Corporation**

*Pulling the Wagon --  
Integrity in Action*

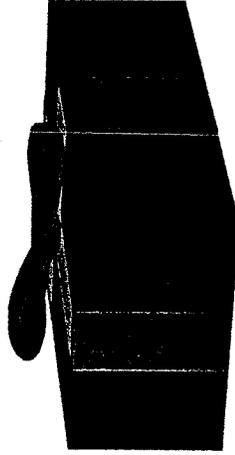
*Corporate Compliance Orientation*

# Conflicts of Interest

## *Gift policy:*

We will not solicit, provide or accept gifts, favors or hospitality from patients, visitors, vendors or other organizations involved in conducting our business. However, the acceptance of modest gifts or entertainment less than \$25 is acceptable. If an employee has any doubt as to the appropriateness of a gift, they should seek guidance from management or Human Resources.

380



HHEC 259-0327  
Confidential Treatment  
Requested by HealthSouth Corp.

(1) **HEALTHSOUTH.**

# Conflicts of Interest

## *Outside Employment and Affiliations*

- In general, HEALTHSOUTH allows employees to hold other jobs as long as such employees can effectively meet the performance standards for the HEALTHSOUTH job.
- We will not have any association or connection with another organization with might result in any conflict with purposes, aims or goals of HEALTHSOUTH.
- We will do business only with individuals and companies on the basis of HEALTHSOUTH's best interests.

381

HHEC 259-0328  
Confidential Treatment  
Requested by HealthSouth Corp.

**(H) HEALTHSOUTH.**

5/16/82 minutes

Tab 62

Capitalization Table MedCenterDirect, Com, Inc.										
Share/Option Strike Price	A	B	C	D	E	Total	A	B	D	E
2,700,000	2,700,000					2,700,000	9.9%	9.7%	9.4%	8.1%
385,000	385,000					385,000	1.4%	1.4%	1.3%	1.2%
825,000	825,000					825,000	3.0%	3.0%	2.9%	2.5%
100,000	100,000					100,000	0.4%	0.4%	0.3%	0.3%
40,000	40,000					40,000	0.1%	0.1%	0.1%	0.1%
Sub Total	4,030,000					4,030,000				
Option pool	6,000,000					6,000,000	21.9%	21.7%	20.9%	17.9%
Sub Total	10,030,000					10,030,000				
New Enterprise Associates					4,800,000	4,800,000				14.3%
HEALTHSOUTH	6,390,583					6,390,583	23.3%	23.1%	22.3%	19.1%
Marin Investments, LLP	5,494,167					5,494,167	20.3%	19.8%	19.2%	16.4%
Marin, Michael D.	722,917					722,917	2.6%	2.6%	2.5%	2.2%
Charitable Foundation	578,333					578,333	2.1%	2.1%	2.0%	1.7%
Honnett, James P	289,167					289,167	1.1%	1.0%	1.0%	0.9%
Hicks, Will	289,167					289,167	1.1%	1.0%	1.0%	0.9%
Strohens, John	289,167					289,167	1.1%	1.0%	1.0%	0.9%
Maddox, Russ	289,167					289,167	1.1%	1.0%	1.0%	0.9%
Owens, William T.	202,417					202,417	0.7%	0.7%	0.7%	0.6%
Gordon, Joel	144,583					144,583	0.5%	0.5%	0.5%	0.4%
Hanson, Eric	144,583					144,583	0.5%	0.5%	0.5%	0.4%
Razzouk, Bill	144,583					144,583	0.5%	0.5%	0.5%	0.4%
Riviere, Daniel	144,583					144,583	0.5%	0.5%	0.5%	0.4%
Thomson, Rob	144,583					144,583	0.5%	0.5%	0.5%	0.4%
Sweid, Swaid	144,583					144,583	0.5%	0.5%	0.5%	0.4%
McClendon, Mac	144,583					144,583	0.5%	0.5%	0.5%	0.4%
Foster, Patrick	115,667					115,667	0.4%	0.4%	0.4%	0.3%
Scrushy, Gerald P.	101,208					101,208	0.4%	0.4%	0.4%	0.3%
Cannan, Thom	101,208					101,208	0.4%	0.4%	0.4%	0.3%
Strong, George	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Chamberlin, Jack	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Givens, Sage	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Enterprise Associates 9, L.P.	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Kins, Phil	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Mark, Chuck	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Nantz, Jessica	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Swiglin, Larry	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Taylor, Larry D.	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Marheimor, Terry	72,292					72,292	0.3%	0.3%	0.3%	0.2%
Brown, P. Daryl	57,833					57,833	0.2%	0.2%	0.2%	0.2%
Crumpler, Sony	57,833					57,833	0.2%	0.2%	0.2%	0.2%
Jayne, David A.	57,833					57,833	0.2%	0.2%	0.2%	0.2%
McVey, Malcolm E. Todd	57,833					57,833	0.2%	0.2%	0.2%	0.2%
Fuller, David B.	43,375					43,375	0.2%	0.2%	0.2%	0.1%
Nico, Vincent	43,375					43,375	0.2%	0.2%	0.2%	0.1%
Smith, Weston	43,375					43,375	0.2%	0.2%	0.2%	0.1%
Bois, Richard	43,375					43,375	0.2%	0.2%	0.2%	0.1%
Brockleman, Kurt	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Chandler, Michael	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Faulkner, Sharon	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Hawkins, Jack H	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Horton, William W.	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Katz, Richard	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Mendez, Lincoln	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Muscato, Mary	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Deigan, Faith	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Tan, Mark	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Livesey, Kenneth K.	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Wilder, Linda	28,917					28,917	0.1%	0.1%	0.1%	0.1%
Sub Total	77,330,000					77,330,000				
Other Investors							0.0%	0.0%	0.0%	0.0%
Lachridge, Stanley		300,000				300,000	0.0%	1.1%	1.0%	0.9%
Coc, Robert			200,000			200,000	0.0%	0.0%	0.7%	0.6%
Kiss M.D., Hurley			50,000			50,000	0.0%	0.0%	0.3%	0.1%
Key People Family				700,000		700,000	0.0%	0.0%	2.4%	2.1%
Sub Total							0.0%	0.0%	0.0%	0.0%
Grand Total	27,400,000	17,700,000	27,950,000	28,650,000	33,450,000	33,450,000	100.0%	100.0%	100.0%	100.0%

Carry forward

33,450,000  
(10,050,000)  
23,400,000

27,310,000 = 6,390,583 / 23,400,000

Per APB 18, Par. 10 the investors voting stock interest in an investee should be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges which may become exercisable to holders of securities of an investee should be disregarded. Therefore, we deducted option shares from the grand total shares to calculate ownership %.

**HEALTHSOUTH,****Clinical Considerations and Implications  
Of Group Therapy Coding  
In the Medicare Population**

Tab 63

7/22/02  
Draft to legal  
4pm Conf call

It is imperative that all administrators, site managers, and clinicians read, understand and comply with material contained within this document. In a memorandum from CMS to the fiscal intermediaries on May 17, 2002, CMS re-defined Group Therapy (CPT code 97150) in the following manner:

Per Program Transmittal 1753:15302, **GROUP THERAPY SERVICES (CODE 97150)** Defined as Pay (payment) for outpatient physical therapy services (which includes outpatient speech-language pathology services) and outpatient occupational therapy services provided simultaneously to two or more individuals by a practitioner as group therapy services. The individuals can be, but need not be performing the same activity. The physician or therapist involved in group therapy services must be in constant attendance, but one-on-one patient contact is not required. (Website link: <http://www.hcfa.gov/pubforms/transmit/R1753B3.pdf>; scroll to page 3)

**Clinical Implications**

This new interpretation of group therapy services has implications relative to how we provide appropriate professional services to and are able to bill for the care provided to our Medicare patients. The definition in this program transmittal specifies the appropriate billing distinctions that should be applied when treating Medicare patients. It stipulates the differences between billing for one to one rehabilitative services using codes within the therapeutic procedures section and the use of the group therapy code. Specifically, that when more than one patient is performing an activity simultaneously, under the direction of a single clinician, that Medicare patients should now be billed using the group therapy (97150) CPT code. Therefore, if a clinician (PT, PTA, OT, COTA, SLP) has two patients that they are supervising in the facility at the same time, and one of those patients is a Medicare recipient, all treatments administered to the Medicare patient would be deemed "Group Therapy" for that particular treatment session – CPT 97150. On the other hand, if a clinician is only supervising one patient, and that patient is a Medicare recipient, then the Group Therapy code does not apply. The normal documentation and codes should be utilized. If at any time during the Medicare patient's session, another patient is supervised, then starting at the time the second patient's supervision began, all subsequent treatments to the Medicare patient become Group Therapy as long as the second patient is present. This definition applies only to Medicare patients, and therefore the billing of group activities as specified by CMS applies only to Medicare patients.

The clinical implication of this interpretation is that in order to bill for one to one professional services (therapeutic procedures section) the Medicare patient must be the only patient under the supervision of the treating therapist. Effective management of this patient population will be critical to maintaining superior functional outcomes, ensuring that the highest quality professional services possible are delivered and that we are appropriately reimbursed for the care we provide. Successfully accomplishing this will require utilizing multiple management options when dealing with Medicare patients, including:

- Scheduling
- Patient Management
- Professional Staff Interactions
- Treatment Selection and Timing
- Appropriate Documentation

**HHEC 414-0177**  
Confidential Treatment  
Requested by HealthSouth Corp.

CONFIDENTIAL TREATMENT  
REQUESTED BY  
FULBRIGHT & JAWORSKI L.L.P.

HRCPRV-00063

## **HEALTHSOUTH,**

### **Scheduling**

Scheduling considerations for Medicare patients should be designed to facilitate one to one professional services and minimize the economic impact of group therapy. These strategies will vary from facility to facility depending on numerous factors, including: facility payer mix, number of licensed clinicians, program considerations (aquatics, vestibular, general orthopedics), hours of operation and new patient volume. In general, time should be allotted to allow the Medicare patient as much time as necessary to accomplish clinical and functional goals on a one to one basis.

- Schedule follow up visits as far into the future as possible from the time of the initial evaluation
- Try to schedule Medicare patients one to one time during the "already" slower times of the day (mid-late morning / early afternoon)
- Utilize other staff to maintain one to one consistency whenever possible
- Be aware of M-W-F / T-TH scheduling variance, if the variance is high try to utilize the slower times for the one to one scheduling of Medicare patients
- Creation of one to one scheduling slots
- Appropriate length of scheduling slots
- Medicare patient tardiness

### **Patient Management**

Clinical patient management starts at the initial evaluation. It is imperative that every effort is made to explain the rehabilitation process and build initial rapport with the patient. The patient must be aware of what to expect on subsequent visits to our facilities to avoid any surprises or confusion. This is the evaluating therapist's responsibility. The patient must understand their role in the rehabilitation process. They need to be an active participant in goal setting, determining what will constitute success in their case. The patient needs to have a complete understanding of the processes that are critical in achieving success in their rehabilitation.

- Participation in goal setting
- Completion of home activities, upgrading these as they progress
- Being on time for treatment sessions
- Understanding the role of the various professionals in charge of their care
- Understanding the various clinical components of their treatment session

### **Professional Staff Interactions**

In order to achieve continuity in one to one and group interactions, licensed clinical staffs need to interact in a manner that utilizes both time and clinical resources efficiently. This interaction will vary from facility to facility and staff to staff. The facility manager is encouraged to discuss the one to one group issue with their clinical and non-clinical staff and devise strategies that will work for their particular site.

Considerations include:

- Discuss the day's schedule in advance to identify patient management issues
- How to request extra one to one time when the next patient arrives, by utilization of other clinical staff
- The process of sharing documentation in cases where a patient is managed by more than one clinician during a treatment session

## HEALTHSOUTH.

### Treatment Selection / Timing

Treatment selection and timing become an even more important issue in light of the group therapy definition for Medicare patients. The one to one time needs to be maximized with clinical strategies that will have the greatest impact on the patient and the achievement of the patient's goals. The clinician needs to understand all the issues involved in these matters. The administrator and facility managers are encouraged to discuss these issues with the clinical staff.

- Evaluation and identification of specific target tissue and appropriate treatment strategy for specific tissue(s)
- Focus on consistent re-assessment of patient status (objective and functional measures) to maximize treatment benefit
- The focus of exercise / neuromuscular re-education activities that need to be performed in the facility
- The use and utilization of passive modalities (effectiveness/elimination of)

### Appropriate Documentation

For facilities documenting using TherapySource (HCAP), the treatment section has been upgraded to allow for the identification and billing of group therapy. In each treatment selection category the clinician will be able to choose "group activity 1" the same way they can choose "exercise activity 1". They will have to name the activity and specify the parameters of each activity. The selections under "group activity" will be linked to the group therapy code (97150).

There may be times when the treatment selection list will consist of an activity or activities that are identified as both a one to one code (therex, neuromuscular re-ed, manual therapy...) and a group code due to these activities being performed in one to one and group settings during previous treatment sessions. Example: "Scapular retractions" may be a one to one code (Therapeutic Exercise 97110) or a group code, depending on if it is performed with or without concurrent supervision of another patient. The clinician will need to pay attention to the treatment list and identify these duplicate codes as performed or not performed for the particular treatment session.

Squats on Barbell	# of people in Group	3
Swimming Strokes	Additional Detail	
Treading Water	Description	Squats on Barbell
Up/Down Pull	Repetitions	10
Walking - Backward	Sets	2
Walking - Forward	Time Elapsed (Min)	10
Walking - Sideways	Tubing Band Color	1
Wall Push Ups	Weight (kg)	5
Wrist Flexion/Extension		
[Aquatic Activity 1]		
[Aquatic Activity 2]		
[Aquatic Activity 3]		
[Aquatic Activity 4]		
[Aquatic Activity 5]		
[Group Activity 1]		
[Group Activity 2]		
[Group Activity 3]		
[Group Activity 4]		
[Group Activity 5]		

<input checked="" type="checkbox"/> Performed	<input type="checkbox"/> Carry Forward
<input type="checkbox"/> Not Performed	
<input type="checkbox"/> Deferred	
Qualifier	
(None)	

Show All  
 Show Documented

CONFIDENTIAL TREATMENT  
REQUESTED BY  
FULBRIGHT & JAWORSKI L.L.P.

Subj: Fw: **\*\*IMPORTANT E-MAIL\*\*** Re: Conference Call with Richard Scrusby & Bill Owens - TODAY  
Date: 7/29/2002 3:00:01 PM Central Daylight Time  
From: Sean.Huffman@healthsouth.com  
To: huvco@aol.com  
Sent from the Internet (Details)

Tab 64

Print, please.

Michael Sean Huffman MS, ATC, PT  
Senior Vice President  
HEALTHSOUTH Corporation

*Bill call  
see*

-----Original Message-----

From: Doyle, Mike <Mike.Doyle@healthsouth.com>  
To: Huffman, Sean <Sean.Huffman@healthsouth.com>  
Sent: Sat Jul 27 11:41:18 2002  
Subject: RE: **\*\*IMPORTANT E-MAIL\*\*** Re: Conference Call with Richard Scrusby & Bill Owens - TODAY

RMS Conference call

- Discussed current financial situation of the company, stock price at 7 and change at the time.
- RMS discussed the capital market being closed down, but our foresight with our bond offering has us way ahead of the competition and allows us to be in control of our capital situation.
- P/E ratio is at 7.62 which is much better than anyone in our business.
- Overall we are in a better position then we have ever been when our stock has turned for the worst.
- Rumors of RMS not willing to sign financials is not true and unfounded.
- Need to continue to work hard and smart and focus on proving Wall Street wrong.

Bill Owens call:

- Reviewed RMS call and stock issues. Discussed street not having faith in our ability and our need to prove them wrong.
- EXPENSE control. We have to get a handle on this and evaluate where we are spending money and is it worthwhile.
- Under performing markets need to be fixed or.....
- Salary expense needs to be tightly controlled.
- Focus on a hard finish to 2002.
- Coming close to the point of being concerned re: expenses.

LT call Friday 4 pm

- CMS group therapy guidelines will affect our operations and we need to ensure our practices are sensitive to the new requirements.
- Document to be released to detail the changes and explain the rule this weekend or Monday.
- Hint to all to focus on Bill's focus .... Expenses.\

I am treating Downtown and will complete the update later today on Mobile and Med Center.

-----Original Message-----

From: Huffman, Sean  
Sent: Friday, July 26, 2002 7:50 PM  
To: Doyle, Mike  
Subject: Re: **\*\*IMPORTANT E-MAIL\*\*** Re: Conference Call with Richard

**HHEC 559-0245**  
Confidential Treatment  
Requested by HealthSouth Corp

Monday, July 29, 2002 America Online: Huvco

Szush (Barker), Audra

From: Taylor, Larry  
 Sent: Thursday, August 01, 2002 8:54 PM  
 To: Szush (Barker), Audra  
 Subject: Fw: Memorandum from William T. Owens - President and Chief Operating Officer  
 Importance: High

Tab 65

Squats on Barbell	# of people in Group	3
Swimming Strokes	Additional Detail	
Treading Water	Description	Squats on Barbell
Up/Down Pull	Repetitions	10
Walking - Backward	Sets	2
Walking - Forward	Time Elapsed (Min)	10
Walking - Sideways	Tubing Band Color	
Wall Push Ups	Weight (kg)	5
Wrist Flexion/Extension		
[Aquatic Activity 1]		
[Aquatic Activity 2]		
[Aquatic Activity 3]		
[Aquatic Activity 4]		
[Aquatic Activity 5]		
[Group Activity 1]	<input type="checkbox"/> Performed	<input type="checkbox"/> Optimized
[Group Activity 2]	<input checked="" type="checkbox"/> Not Performed	<input type="checkbox"/> Carry Forward
[Group Activity 3]	<input type="checkbox"/> Deleted	
[Group Activity 4]	Qualifier	
[Group Activity 5]	(none)	

Show All  
 Show Documented

**HEALTHSOUTH.**

print  
 Larry D. Taylor  
 President and Chief Operating Officer  
 Ambulatory Services

-----Original Message-----  
 From: Hodges, Pam <Pam.Hodges@healthsouth.com>  
 To: OPS - IP Center Administrators <IPCA2@healthsouth.com>; OPS - IP Clinical Advisory Board <ipcab2@healthsouth.com>; OPS - IP Market Leaders <IPML2@healthsouth.com>; OPS - IP Market Managers <IPMM2@healthsouth.com>; OPS - IP Senior Management <ipsm2@healthsouth.com>; OPS - Market Coordinators <mkccoord@healthsouth.com>; OPS - Market Leaders <MKTLeaders2@healthsouth.com>; OPS - Market Managers <mkmanagers2@healthsouth.com>; OPS - OP Center Administrators <OPCA2@healthsouth.com>; OPS - OP Clinical Coordinators <opcc2@healthsouth.com>  
 CC: Foster, Pat <Pat.Foster@healthsouth.com>; Taylor, Larry <Larry.Taylor@healthsouth.com>; Le, Lisa <Lisa.Le@healthsouth.com>; Arrigo, Chris <Chris.Arrigo@healthsouth.com>  
 Sent: Thu Aug 01 17:19:40 2002  
 Subject: Memorandum from William T. Owens - President and Chief Operating Officer

<<Untitled Attachment>>  
 INTERNAL MEMORANDUM  
 To: Distribution List  
 From: William T. Owens, President and Chief Operating Officer  
 Date: August 1, 2002  
 Subject: Group Therapy

Clinical Considerations and Implications  
 Of Group Therapy Coding  
 In the Medicare Population

**HHEC 301-1247**  
 Confidential Treatment  
 Requested by HealthSouth Corp.

It is imperative that all administrators, site managers, and clinicians read, understand and comply with material contained within this document. In Program Transmittal 1753, issued from CMS to the carriers on May 17, 2002, CMS effectively re-defined Group Therapy (CPT code 97150) by directing the carriers to pay for certain therapy services in the following manner:

15302. GROUP THERAPY SERVICES (CODE 97150) Pay for outpatient physical therapy services (which includes outpatient speech-language pathology services) and outpatient occupational therapy services provided simultaneously to two or more individuals by a practitioner as group therapy services. The individuals can be, but need not be performing the same activity. The physician or therapist involved in group therapy services must be in constant attendance, but one-on-one patient contact is not required. (Website link: <<http://www.hcfa.gov/pubforms/transmit/R1753B3.pdf>> scroll to page 3)

#### Clinical Implications

This new interpretation of group therapy services has implications relative to how we provide appropriate professional services to and are able to bill for the care provided to our Medicare patients. The definition in this program transmittal specifies the appropriate billing distinctions that should be applied when treating Medicare patients. It stipulates the differences between billing for one to one rehabilitative services using codes within the therapeutic procedures section and the use of the group therapy code. Specifically, under this new directive, when more than one patient is performing any activities simultaneously under the direction of a single clinician, all such Medicare patients should now be billed using the group therapy (97150) CPT code. Therefore, if a clinician (PT, PTA, OT, COTA, SLP) is treating two patients in the facility at the same time, and one of those patients is a Medicare recipient, all treatments administered to the Medicare patient would be deemed "Group Therapy" for that particular treatment session - CPT 97150. The exception to this is when a patient is treated with a supervised modality. The one-on-one treatment requirement does not apply when using supervised modalities (97010 Hot/Cold Pack, 97012 Mechanical Traction, 97014 Unattended Electrical Stimulation, 97016 Vasopneumatic Device, 97018 Paraffin Bath, 97020 Microwave, 97022 Whirlpool, 97024 Diathermy, 97026 Infrared, and 97028 Ultraviolet). On the other hand, if a clinician is only supervising one patient, and that patient is a Medicare recipient, then the Group Therapy code does not apply. The normal documentation and codes should be utilized in that circumstance. If at any time during the Medicare patient's session the clinician begins directing the treatment of another patient (whether or not the second patient is a Medicare patient), then starting at the time the second patient's supervision began, all subsequent treatments to the Medicare patient become Group Therapy as long as the second patient is present. This definition applies only to Medicare patients, and therefore the billing of group activities as specified by CMS applies only to Medicare patients.

The clinical implication of this interpretation is that, in order to bill for one to one professional services (therapeutic procedures section) the Medicare patient must be the only patient under the supervision of the treating therapist. Effective management of this patient population will be critical to maintaining superior functional outcomes, ensuring that the highest quality professional services possible are delivered and ensuring that we are appropriately reimbursed for the care we provide. Successfully accomplishing this will require utilizing multiple management options when dealing with Medicare patients, including:

- \* Scheduling
- \* Patient Management
- \* Professional Staff Interactions
- \* Treatment Selection and Timing
- \* Appropriate Documentation

#### Scheduling

Scheduling considerations for Medicare patients should be designed to facilitate one to one professional services and minimize the economic impact of group therapy. These strategies will vary from facility to facility depending on numerous factors, including: facility payer mix, number of licensed clinicians, program considerations (aquatics, vestibular, general orthopedics), hours of operation and new patient volume. In general, time should be allotted to allow the Medicare patient as much time as necessary to

accomplish clinical and functional goals on a one to one basis.

- \* Schedule follow up visits as far into the future as possible from the time of the initial evaluation
- \* Try to schedule Medicare patients one to one time during the "already" slower times of the day (mid-late morning / early afternoon)
- \* Utilize other staff to maintain one to one consistency whenever possible
- \* Be aware of M-W-F / T-TH scheduling variance; if the variance is high try to utilize the slower times for the one to one scheduling of Medicare patients
- \* Creation of one to one scheduling slots
- \* Appropriate length of scheduling slots
- \* Medicare patient tardiness

#### Patient Management

Clinical patient management starts at the initial evaluation. It is imperative that every effort be made to explain the rehabilitation process and build initial rapport with the patient. The patient must be aware of what to expect on subsequent visits to our facilities to avoid any surprises or confusion. This is the evaluating therapist's responsibility. The patient must understand his or her role in the rehabilitation process. The patient needs to be an active participant in goal setting -- determining what will constitute success in his or her case. The patient needs to have a complete understanding of the processes that are critical in achieving success in his or her rehabilitation.

- \* Participation in goal setting
- \* Completion of home activities, upgrading these as they progress
- \* Being on time for treatment sessions
- \* Understanding the role of the various professionals in charge of his or her care
- \* Understanding the various clinical components of his or her treatment session

#### Professional Staff Interactions

In order to achieve continuity in one to one and group interactions, licensed clinical staffs need to interact in a manner that utilizes both time and clinical resources efficiently. This interaction will vary from facility to facility and staff to staff. The facility manager is encouraged to discuss the one to one/group issue with clinical and non-clinical staff and devise strategies that will work for their particular site.

Considerations include:

- \* Discuss the day's schedule in advance to identify patient management issues
- \* How to request extra one to one time when the next patient arrives, by utilization of other clinical staff
- \* The process of sharing documentation in cases where a patient is managed by more than one clinician during a treatment session

#### Treatment Selection / Timing

Treatment selection and timing become even more important issues in light of the group therapy definition for Medicare patients. The one to one time needs to be maximized with clinical strategies that will have the greatest impact on the patient and the achievement of the patient's goals. The clinician needs to understand all the issues involved in these matters. The administrator and facility managers are encouraged to discuss these issues with the clinical staff.

- \* Evaluation and identification of specific target tissue and appropriate treatment strategy for specific tissue(s)
- \* Focus on consistent re-assessment of patient status (objective and functional measures) to maximize treatment benefit
- \* The focus of exercise / neuromuscular re-education activities that need to be performed in the facility
- \* The use and utilization of passive modalities (effectiveness, elimination of)

#### Appropriate Documentation

For facilities documenting using TherapySource (HCAP), the treatment section has been

upgraded to allow for the identification and billing of group therapy. In each treatment selection category clinicians will be able to choose "group activity 1" the same way they can choose "exercise activity 1". They will have to name the activity and specify the parameters of each activity. The selections under "group activity" will be linked to the group therapy code (97150).

There may be times when the treatment selection list will consist of an activity or activities that are identified as both a one to one code (therex, neuromuscular re-ed, manual therapy...) and a group code due to these activities being performed in both one to one and group settings during previous treatment sessions. Example: "Scapular retractions" may be a one to one code (Therapeutic Exercise 97110) or a group code, depending on if it is performed with or without concurrent supervision of another patient. The clinician will need to pay attention to the treatment list and identify these duplicate codes as performed or not performed for the particular treatment session.

<<Untitled Attachment>>

When a patient is treated by two clinicians one to one in a single setting, both clinicians' signatures should appear on the note. The clinicians will have to determine the primary and secondary signature status. Documentation issues should be discussed by the administrator / facility manager with the clinical staff to ensure clarity and facilitate understanding relative to the appropriate management of this issue.

#### Summary

The management and clinical teams within each facility are strongly encouraged to discuss the best course of action in their facility to minimize the clinical and financial impact of the new group therapy definition. Resources are available through corporate management and Regional Clinical Coordinators to assist administrators and facility managers with the functional implementation and appropriate compliance with this process.

For assistance in implementation or interpretation fax inquiries to: (205) 969-4798  
 Inpatient Division Attention: Jean Davis  
 Ambulatory Division Attention: Chris Arrigo

FULBRIGHT & JAWORSKI L.L.P.  
A REGISTERED LIMITED LIABILITY PARTNERSHIP  
801 PENNSYLVANIA AVENUE, N.W.  
WASHINGTON, D.C. 20004-2623

Tab 66

MEMORANDUM

TO: John Hanson                      ATTORNEY-CLIENT PRIVILEGED MATERIAL  
Robert May                          ATTORNEY WORK PRODUCT

DATE: October 31, 2002

FROM: Richard W. Beckler   
Matthew H. Kirtland

RE: Notice Regarding Document Review

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At the request of the Board of Directors of HealthSouth Corporation, Fulbright & Jaworski L.L.P. ("Fulbright") conducted a limited review of the shredded material removed from the large shredder in the file room on the fifth floor of the Executive Office Tower. Please find attached photocopies of the shreds that matched our review criteria. This supplements the reference Fulbright made to "mittal 1753" and "175 m" on page 1, paragraph 2 of the October 29, 2002 report to the Board of Directors.

cc: Hal Hirsch  
Peter V.B. Unger  
Carl E. Kaplan  
Neil Gold  
Lanny Davis

#33354512v1<

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

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CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 003424

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CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 003425

4/14/03

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE  
IN AND FOR NEW CASTLE COUNTY

EDWARD R. BIONDI, individually )  
and derivatively on behalf of )  
HEALTHSOUTH CORPORATION, )  
a Delaware corporation, )

Plaintiff, )

C.A. No. 19896-NC

v. )

RICHARD M. SCRUSHY, )  
GEORGE H. STRONG, JOHN S. )  
CHAMBERLIN, CHARLES W. )  
NEWHALL, C. SAGE GIVENS, )  
JOEL C. GORDON, LARRY D. )  
STRIPLIN, JR., WILLIAM T. )  
OWENS, and PHILLIP C. )  
WATKINS, M.D., )

Defendants, )

Tab 67

and )

HEALTHSOUTH CORPORATION, )  
a Delaware corporation, )

Nominal Defendant. )

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TV. The Federal Securities Actions

On August 28, 2002 — the day that the original Tucker Complaint was filed — the first of seventeen shareholder class actions were filed against HealthSouth and certain of its directors in the United States District Court for the Northern District of Alabama. Each of these suits (the “Federal Securities Complaints”) attacks the sales of HealthSouth stock by company insiders during the period in which it is alleged that they knew that the Group Rate Policy would adversely affect HealthSouth but before Health South disclosed those effects to the market. In particular, the complaints allege a violation of Securities Exchange Act § 10(b) and Securities and Exchange Commission Rule 10b-5, as well as § 20(a) of the Exchange Act. All of the Alabama Federal Actions have been consolidated before Judge Karon O. Bowdre, and that court is now considering the appointment of lead counsel.

V. The Creation of the HealthSouth Special Litigation Committee

On September 17, 2002, the HealthSouth board formed the Special Litigation Committee. The board did so by a series of resolutions that are confusing. The basic charge of the SLC was set forth as follows:

the Board of Directors hereby constitutes and appoints a Special Litigation Committee . . . to investigate, review and analyze: (1) the facts, transactions, events and circumstances surrounding

the claims made in such Tucker Action and any other actions or proceedings which may be filed which relate or are alleged to relate to any event or transaction which is a subject in or of the Tucker Action; and (2) to the extent the Business Judgment Rule may be determined to be applicable thereto or to the extent claims of a derivative nature may be asserted in respect thereto, any events or transactions which are or may become the subject of any of the pending federal court class actions which have been filed against the Company since August 27, 2002 in the United States District Court for the Northern District of Alabama.<sup>3</sup>

Furthermore, the SLC was given the mandate to:

[c]onsider and determine whether or not prosecution or continuation of such claims and actions is in the best interests of the Company and its shareholders, and what action the Company should take with respect thereto . . .

[h]ave and may exercise in connection with its investigation and determination all the powers and authority of the Board of Directors, which is hereby delegated to the Committee, and such other powers as are accorded to a committee under applicable law . . .<sup>4</sup>

This delegation of power to the SLC was clear enough and in accordance with expected practice. The problem is that the board further resolved that nothing in its empowerment of the SLC was:

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<sup>3</sup> Bouchard Aff. Ex. L.

<sup>4</sup> *Id.*

intended to moot or waive the Company's planned motions to dismiss or stay the Tucker Action for lack of standing and/or failure to state a claim upon which relief may be granted and failure to comply with the requirements of Rules 12(b)(6) and 23.1, Alabama Rules of Civil Procedure; provided, however, that the Committee should have full power and discretion to *recommend* that any Company motion or pleading be changed, withdrawn, or supplemented by additional or substituted pleadings or motions of the Committee or the Company, or both, as shall be deemed appropriate . . .<sup>5</sup>

Read plainly, this resolution seemed to limit the SLC's authority to prevent the company from seeking dismissal of the Tucker Action, with or without the SLC's blessing. Although the SLC could "recommend" otherwise, nothing in the prior resolution authorizing the SLC to act for the board was "intended to moot or waive" the company's planned motions for dismissal.<sup>6</sup> This intent is further demonstrated by earlier language in the resolutions that indicated the board's desire "to preserve to the Company and the Board" the right to seek dismissal.<sup>7</sup>

To confuse matters further, however, the board also resolved that the "determinations made by the [SLC] shall be final, shall not be subject to

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<sup>5</sup> *Id.* (emphasis added).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

review by the Board of Directors and shall in all respects be binding upon the Company. . .”<sup>8</sup>

As the Delaware Complaint argues, the SLC’s original mandate was not as clear as one would hope. The Delaware plaintiffs contend that the SLC was left without full power to control HealthSouth’s reaction to the litigations and most notably could not prevent the “Company and the Board” from pursuing dismissal of the suits over the SLC’s “recommend[ation].”<sup>9</sup>

In an attempt to dispel these concerns, HealthSouth amended its SLC’s charge *in advance of the SLC’s filing of its reply brief*. The amendment clarifies the SLC’s authority to act fully for HealthSouth and deletes the references to the company’s independent ability to file dismissal or stay motions.

This late amendment, however, addresses but one of the facts that the Delaware plaintiffs point to support their argument that the HealthSouth SLC is fatally compromised. I now describe the others.

#### VI. The Strange Early Days of the HealthSouth SLC

One of the obvious purposes for forming a special litigation committee is to promote confidence in the integrity of corporate

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

decision making by vesting the company's power to respond to accusations of serious misconduct by high officials in an impartial group of independent directors. By forming a committee whose fairness and objectivity cannot be reasonably questioned, giving them the resources to retain advisors, and granting them the freedom to do a thorough investigation and to pursue claims against wrongdoers, the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the company itself.

Critical to the accomplishment of these objectives, however, is the proper composition and empowerment of the committee. If a special litigation committee is comprised of directors with compromising ties to the key officials who are suspected of malfeasance, if the committee is not fully empowered to act for the company without approval by the full board, or if the committee behaves in a manner inconsistent with the duty to carefully and open-mindedly investigate the alleged wrongdoing, its ability to instill confidence is, at best, compromised and, at worst, inutile.

Regrettably, the HealthSouth SLC's early days involved several confidence-shaking events.

They begin with the composition of the SLC itself. When first formed, the SLC was to be comprised of an existing HealthSouth director,

Larry D. Striplin, Jr., and a newly appointed director, Jon Hanson. Of course, one of the key reasons for the formation of a special litigation committee is to insulate the company's decision making process from the influence of those under suspicion. In this matter, Scrusby is the key target of all the lawsuits alleging improper trading in advance of the company's disclosure of the impact of the Group Rate Policy.

The selection of Striplin and Hanson to comprise the SLC was thus somewhat surprising. Both of them serve with Scrusby on the board of the National Football Foundation and College Hall of Fame, Inc., *of which Hanson has been the Chairman since 1994*. One of that organization's key awards is named for HealthSouth, suggesting that the company, under Scrusby's managerial leadership, has been quite generous with a cause very important to Hanson. Contributing to the disquiet is the long-standing personal ties between Striplin and Scrusby, who are both large contributors to college sports programs in Alabama. Indeed, a stadium at a college in Alabama is named Scrusby-Striplin Field.

The same day that the SLC was created with this questionable membership, HealthSouth took another action that further undercut the SLC's credibility. For one thing, HealthSouth hired the law firm of Fulbright & Jaworski L.L.P. to investigate the securities trading issues that

were at the heart of the pending lawsuits — *i.e.*, the same issue supposedly entrusted to the SLC. The retention of Fulbright & Jaworski was announced on the same day as the SLC was formed.

Just six days later, HealthSouth put out a press release, which quotes company director and Scrushy's new successor as CEO, William Owens, to the following effect:

I want to make it clear that Richard M. Scrushy had absolutely no knowledge about any change in Medicare reimbursement rules until August 6, 2002, and none of us had any knowledge whatsoever that a possible rule change would have a material, financial impact on our company until August 15, 2002.<sup>10</sup>

This statement was rather unusual, coming from the CEO of a company that had just chosen to form the SLC to investigate, among other things, the very question of whether Scrushy and other HealthSouth insiders had traded improperly while recognizing the adverse effect the Group Rate Policy would have on the company.

The next development came on October 1, 2002 when HealthSouth announced the election of Robert P. May to the board as a putatively independent director. May soon became Chairman of the SLC. A few days thereafter, SLC member Striplin resigned in the face of press reports

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<sup>10</sup> Brown Aff. Ex. N.

questioning his ability to serve impartially, especially in view of a large contract that his glass company had recently received from HealthSouth. When he resigned, Striplin was publicly quoted issuing this strong statement supporting Scrushy: "He is a great leader doing a great job. Find another health care company that has done what HealthSouth has done."<sup>11</sup>

The next eyebrow-raising event occurred on October 30, 2002.

HealthSouth issued a press release entitled:

**HEALTHSOUTH Chairman Richard Scrushy  
Cleared By Outside Investigation Of Advance  
Knowledge Of Medicare Rule Change Prior To  
Stock Transactions<sup>12</sup>**

The body of the release said that Fulbright & Jaworski had issued a report stating that Scrushy had "no knowledge of any Medicare reimbursement rule change or its financial impact on the Company until two months after he sold stock on May 14 due to expiring stock options and a week after he repaid a stock loan on July 3 1 ."<sup>13</sup> As mentioned earlier,

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<sup>11</sup> Brown Aff. Ex. E.

<sup>12</sup> Brown Aff. Ex. U (emphasis in original).

<sup>13</sup> *Id.*

Fulbright & Jaworski did not work for the SLC, which was only in the early stages of its own work.<sup>14</sup>

*Despite those important facts, SLC Chairman May was quoted in the HealthSouth press release to this effect:*

This thorough outside review conducted by Fulbright & Jaworski puts to rest any question whether Mr. Scrushy had any inkling or knowledge of the Medicare reimbursement rule change or its impact prior to his stock transactions in May and July 2002.<sup>15</sup>

Soon after HealthSouth's release trumpeting the exonerating effect of the Fulbright & Jaworski report, the company was forced to issue another disclosure. Fulbright & Jaworski was apparently uncomfortable with the company's initial release. Although the Fulbright & Jaworski report apparently uncovered "no oral interview or written document"<sup>16</sup> that established that Scrushy was aware of the effect of the Group Rate Policy at the time of his May trade and the July Buyback, the firm was expressing "no

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<sup>14</sup> Only seven days before, the SLC's counsel had written to the plaintiffs in the Delaware Action asking for suggestions "with respect to the scope and substance of the Committee's work." Brown Aff. Ex. W. The letter asked for a reply within two to three weeks. *Id.* Counsel for Delaware plaintiff Biondi replied in a detailed letter on November 8, 2002. According to the Delaware plaintiffs, they have not heard further from the SLC.

<sup>15</sup> *Id.* In its reply brief, the SLC does not deny that May made this statement but attempts to slight it as a "statement attributed to him in a press release." SLC Reply Br. at 28. That response is weak tea. The press release was put out by HealthSouth itself. May has not filed any affidavit denying the statement, and there is no evidence that HealthSouth ever issued a retraction on his behalf.

<sup>16</sup> Brown Aff. Ex. U.

federal insider trading claims, it may well be that the federal adjudications should precede the determination of the state law issues and that any schedule in this case should reflect that consideration. Although in one important respect there are state law issues that diverge to some extent from the basis for the federal suits — *i.e.*, the question of whether the Buyback was an unfair interested transaction under state law — in most respects it would seem to be helpful to have a prior federal adjudication of whether the trading directors possessed material, non-public information at the time of their trades and acted with *scienter*.

For now, however, I simply deny the SLC's application for a stay in deference to the Tucker Action, without prejudice to a later, similar motion.

B. Should This Action Be Staved Until the SLC's Completes Its Investigation?

The SLC next contends that a stay must be granted to permit it to finish its investigation without the distraction and costs that would occur if this litigation proceeds at the same time. In support of that proposition, the SLC cites *hombook* Delaware law, including this statement from the case of *Abbey v. Computer & Communications Technology Corp.*:

If *Zapata* is to be meaningful, then it would seem that such an independent committee, once appointed, should be afforded a reasonable time to carry out its function. It would likewise seem reasonable to hold normal discovery and other

matters in abeyance during this interval. If a derivative plaintiff were to be permitted to depose corporate officers and directors and to demand production of corporate documents, etc. at the same time that a duly authorized litigation committee was investigating whether or not it would be in the best interests of the corporation to permit the suit to go forward, the very justification for the creating of the litigation committee in the first place might well be subverted.<sup>36</sup>

The Delaware plaintiffs admit that the general rule under Delaware law is that a stay must be granted when a special litigation committee is formed to consider whether derivative actions should be prosecuted.<sup>37</sup> But they argue that even a sound general rule must admit of exceptions in compelling circumstances, which include a situation when it is clear that the special litigation committee in question can reach only one determination — a decision that the derivative suit should be prosecuted — that has a chance of being accorded deference under the test set forth in *Zapata Corp. v. Maldonado*.<sup>38</sup>

As a prerequisite to determining whether to defer to the business judgment of a special litigation committee to terminate a derivative suit, a

<sup>36</sup> 457 A.2d 368,375 (Del. Ch. 1983); see also *Kaplan v. Wyatt*, 484 A.2d 501,510 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

<sup>37</sup> Other cases to this effect include: *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206, 1210-11 & n.16 (Del. Ch. 2002); *Katell v. Morgan Stanley Group, Inc.*, 1993 WL 390525, at \*4 (Del. Ch. Sept. 27, 1993); *Pompeo v. Hefner*, 1983 WL 20284, at \*2-\*3 (Del. Ch. Mar. 23, 1983).

<sup>38</sup> 430 A.2d 779 (Del. 1981).

court must conduct an inquiry into the “independence and *good* faith of the committee and the bases supporting its conclusions.”<sup>39</sup> The court *may* defer to the committee’s recommendation to terminate so long as that committee proves that its members: (1) were independent; (2) acted in good faith; and (3) had a reasonable basis for their conclusions.<sup>40</sup> Ordinarily, and for obvious reasons, the inquiry whether the SLC’s recommendation should be respected is usually made after the committee has concluded its investigation and issued its report. In the meantime, when the committee asks for a stay to give itself breathing room to do its job without distraction from the underlying litigation’s procession, the court almost invariably grants the motion.

One of the obvious reasons for this normal practice is that in most cases a facial attack on the independence of the special litigation committee at the time of the stay application would be futile. After all, the purpose of forming a special litigation committee is to entrust the fate of the lawsuit to directors whose impartiality cannot reasonably be questioned. Thus, good

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<sup>39</sup> *Id.* at 788.

<sup>40</sup> See *id.* at 788-89. Even if a special litigation committee proves these factors to the court’s satisfaction, the court may, in its discretion, exercise its own judgment regarding whether the suit should proceed. See *id.* at 789. Although this is said to be an oxymoronic judicial exercise of “business judgment,” its purpose is to provide a safeguard against the danger that the difficult-to-detect influence of fellow-feeling among directors (i.e., so-called “structural bias”) does not cause cessation of meritorious litigation valuable to the company.

corporate practice involves the selection of special committee members who would be characterized as *prima facie* independent if that issue was relevant to, for example, a motion to dismiss under Court of Chancery Rule 12(b)(6) or Rule 23.1. Moreover, even if the *prima facie* independence of the special litigation committee is a litigable issue, judicial economy is served by permitting that issue to be addressed after the committee has issued its report, because the court may then consider questions of committee independence at the same time it examines the reasonableness of the bases for the committee's conclusion.<sup>41</sup> Therefore, if there is any litigable doubt about whether a special litigation committee will ultimately be found capable of independently issuing a report recommending the termination of derivative litigation that will command deference under *Zapata*, the court should stay the litigation for a reasonable period of time to permit the committee to finish its work.

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<sup>41</sup> *In Pompeo v. Hefner*, 1983 WL 20284, the plaintiffs argued that a stay motion should be denied because the special litigation committee had been appointed by the wrongdoers under investigation. The court rejected that argument, which, if adopted, would tend to denude the special litigation committee concept of all utility. In so doing, the court adhered to the view that the appropriate time to evaluate the committee's independence is after it files its report. I agree with *Pompeo* that this is the general rule, which should give way only in highly unusual circumstances such as those present here.

One can readily agree with these principles and still find appeal in the Delaware plaintiffs' argument that a stay should not be granted when it is apparent, based on the undisputed facts in the record at the time of the stay motion, that the special litigation committee does not satisfy the *Zapata* requirement of independence. Put differently, it would be futile and wasteful to issue a stay when the undisputed facts will make it impossible for the court later to accept a decision of the special litigation committee to terminate the derivative litigation because the committee will not be able to satisfy its burden under *Zapata* to show that it exercised an independent business judgment.

I agree with the Delaware plaintiffs that the general rule that a stay should issue is subject to exception in an atypical case when, based on the undisputed facts in the stay motion record, the committee's later decision to terminate the litigation could not command respect under *Zapata*. I also agree with the plaintiffs that this case warrants the application of that very narrow exception.<sup>42</sup>

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<sup>42</sup> This is not the first case denying a stay application by a special litigation committee. In *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, 1996 WL 33167168 (Del. Ch. June 6, 1996), Chancellor Allen denied a stay because the committee's motion came well after substantial discovery and heated motion practice had already taken place. See *id.* at \*2 & \*9-\* 10. Although it involved a much different context, the *Carlton* ruling does demonstrate that the general rule favoring stays admits of limited exceptions.

The case presents an odd confluence of unusual and highly troubling facts. Taken together, these undisputed facts convince me that the **HealthSouth** SLC could not meet its burden to prove independence, if it eventually decided to seek termination of this action and the other pending derivative actions. If the only question about the SLC's independence was whether SLC member Hanson's service as Chairman of the National Football Foundation and College Hall of Fame, Inc. alongside Scrushy, a fellow director and benefactor of that institution, compromised his independence, I would not deny a stay but would allow that question to be litigated after the SLC reported.

Combine that fact with the, at best, begrudging and, at worst, inadequate, original delegation of authority to the **HealthSouth** SLC, a delegation that left the board litigating to dismiss the derivative suits at the same time as the SLC was supposedly considering their merits. Even then, I still would not have denied a stay, especially given the (albeit very late) clarification of the SLC's authority by the **HealthSouth** board.

Take those factors and add the strange decision of the company to retain Fulbright & Jaworski to conduct an investigation in advance of the SLC and under the purview of the whole board. Then add the company's new CEO's (defendant Owens's) decision to trumpet the Fulbright &

Jaworski report as exonerating and to use it as a reason to proclaim his confidence in the innocence of Scrusby, only to have the Fulbright & Jaworski firm undercut that interpretation of its findings. At that point, is there still an argument for a stay? But go further and heap on top of that the resignation of SLC member — and fellow National Football Foundation and College Hall of Fame director Striplin — in the face of public pressure and Striplin's parting public statement that Scrusby did nothing wrong. Would that have broken the camel's back? Who knows? It does not matter.

Because there is one fact alone that would warrant denying a stay and that, in combination with these other factors, makes the denial of a stay an easy call: the public announcement by the SLC's Chairman, director May, of his opinion that the Fulbright & Jaworski report vindicated Scrusby. This extraordinary announcement came at a time when the SLC's own investigation was just getting underway.

*Zapata* presents an opportunity for a board that cannot act impartially as a whole to vest control of derivative litigation in a trustworthy committee of the board — *i.e.*, one that is not compromised in its ability to act impartially. The composition and conduct of a special litigation committee therefore must be such as to instill confidence in the judiciary and, as

important, the stockholders of the company that the committee can act with integrity and objectivity.

How can the court and the company's stockholders reasonably repose confidence in an SLC whose Chairman has publicly and prematurely issued statements exculpating one of the key company insiders whose conduct is supposed to be impartially investigated by the SLC? The answer is that they cannot. Even if the SLC later issues a report in favor of dismissal that reads well and that appears to be factually supported, there will always linger a reasonable doubt that its investigation was designed to paper a decision that had already been made. When May's statement is combined with the other record facts, most notably his SLC colleague Hanson's service with Scrushy (and former SLC member Striplin) on the board of a foundation that is obviously meaningful to them, it is inconceivable that the SLC will ever be able to meet its *Zapata* burden in support of a motion to terminate this litigation.<sup>43</sup>

---

<sup>43</sup> This conclusion is reinforced by the nature of the claims raised in the Delaware Action. Whether the claims are meritorious depends in large measure on the knowledge and state of mind of the HealthSouth director-defendants who sold stock at times when they allegedly knew the adverse ramifications of the Group Rate Policy. Therefore, the determination to exonerate them will largely involve a subjective determination of the director-defendants' candor and good faith, given that there will be circumstantial evidence that at least some of them (e.g., Scrushy) should have understood the consequences of the Group Rate Policy when they sold. As a result, the SLC's ability to make that judgment impartially is critical.

Now, I suppose it can be argued that the motion to stay should be granted because the SLC might decide ultimately to support the procession of the litigations. But it seems to me wasteful to stay litigation for the purpose of allowing the SLC to announce its support for the procession of the derivative suits, when a contrary decision to terminate the litigation must necessarily be rejected because the SLC cannot demonstrate its independence. Nor is it apparent to me why the HealthSouth SLC's views on the appropriate forum in which to litigate the derivative claims raised in the Delaware Action and the overlapping claims in the Tucker Action are important. Given the record here, this court would have the same reason to doubt the SLC's independence regarding the issue of forum selection as it would about whether the cases should proceed at all.

**Wylar, Andreas**

From: Wylar, Andreas  
 Sent: Thursday, February 27, 2003 12:13 PM  
 To: Bawden, David; Riddell, Gary; Franks, Iain

Summary of transactions, guaranteed by Healthsouth  
 -----

Tab 68

Borrower: Parking Deck LLC  
 Guarantor: HRC  
 Amount: \$ 6 mio.  
 Approved: 10/08/2001  
 Maturity: 09/30/2002 - extension approved to 10/01/2002  
 Purpose: Parking facility, adjacent to HRC's Birmingham (AL) hospital  
 Sale-and-Lease-back  
 Repayment: Repaid by Healthsouth

Borrower: First Cambridge HCI  
 Guarantor: HRC  
 Amount: \$ 84.5 mio. (initially approved take + hold \$ 45 mio.)  
 Approved: 12/31/2001  
 Maturity: 12/26/2002 - extension approved to 01/02/2003  
 Purpose: Sale-and-Lease-back of 14 hospitals  
 Repayment: Repaid by Healthsouth

Borrower: MedcenterDirect  
 Guarantor: HRC  
 Amount: \$ 15 mio. / approved 03/30/2001 to 10/31/2002  
 \$ 15 mio. / approved 05/04/2001 to 03/31/2002 (first extension)  
 \$ 20 mio. / approved 03/28/2002 to 03/31/2003 (second extension and  
 increase by \$ 5 mio.)  
 Purpose: MedCenterDirect provides IT based solutions to healthcare providers for  
 ordering inventory.  
 General corporates purposes.  
 Repayment: Due 03/31/2003

Let me know if you have questions or need additional information.

Andreas

Nov-18-03 04:33pm From:House Energy & Commerce Cmte Ford 202-226-2447 T-561 P.002 F-660

 **ERNST & YOUNG LLP**

# Internal Correspondence

# South Region

April 3, 1995

To: G. Marcus Neas

Tab 69

From: James P. Conley 

HEALTHSOUTH Corp.

I enclose a copy of a report prepared by the Center for Financial Research and Analysis on our client HEALTHSOUTH Corp. *Please do not copy or send the report to the client.*

Please review the comments in this report, investigate them as you deem appropriate, and prepare a written report to me by April 19.

Enclosure

EYDF 035926  
CONFIDENTIAL

18-03 04:33pm From:House Energy & Commerce Cmte Ford 202-226-2447 T-561 P.003 F-660  
NT BY:ERNST & YOUNG LLP : 3-24-95 :12:18PM : NEW YORK ALABAMA



**HEALTHSOUTH Corp.**

**March 9, 1995**

**Center for Financial Research & Analysis**  
**10800 Mazwood Place**  
**Rockville, MD 20852-3526**  
**Phone: (301) 530-8224 • Fax: (301) 530-1963**

EYDF 035927  
CONFIDENTIAL

<b>HEALTHSOUTH Corp.</b>	
<b>Two Perimeter Park South Birmingham, Alabama 36243 (205) 967-7116</b>	
<i>Primary SIC Code: 8093</i>	<i>3/8/93 Close: \$39</i>
<i>Ticker Symbol: HRC</i>	<i>Prior Month: \$37.625 - 40.625</i>
<i>Exchange: NYSE</i>	<i>52-Week: \$25.25 - 41.25</i>
<i>1994 Fiscal Year-End: 12/31/94</i>	<i>P/E Ratio: 28</i>
<i>Auditor: Ernst &amp; Young</i>	<i>Mkt. Cap.: \$1.17 billion</i>

HEALTHSOUTH Corp. ("HEALTHSOUTH"), formerly known as HEALTHSOUTH Rehabilitation Corporation (until January 1995), is the nation's largest provider of rehabilitative healthcare services. The Company has established interdisciplinary programs for the rehabilitation of patients experiencing disability due to a wide variety of physical conditions, such as stroke, head injury, orthopaedic problems, neuromuscular disease, and sports-related injuries. Such services include physical therapy, sports medicine, work hardening, neurorehabilitation, occupational therapy, respiratory therapy, speech-language pathology, and rehabilitation nursing. The Company's medical center facilities also provide general and specialty medical and surgical healthcare services.

HEALTHSOUTH has articulated the objective of being the provider of choice for patients, physicians, and payors for inpatient and outpatient rehabilitative healthcare services throughout the United States. At September 30, 1994, the Company had 344 locations in 31 states, the District of Columbia, and Ontario, Canada, including 106 outpatient rehabilitation centers and 103 associated satellite clinics, 41 inpatient rehabilitation facilities with 41 associated satellite outpatient clinics, five medical centers, and 41 locations providing other patient care services.

#### FINANCIAL SUMMARY

(\$ millions)	9 Months 1994	9 Months 1993	% Change	1993	1992	% Change
Sales	739.8	357.0	107%	482.3	407.0	19%
Operating Income	100.4	50.5	99%	70.2	56.6	24%
Net Income	40.0	28.0	43%	6.7	29.7	(77%)
Working Capital	180.1	175.4	3%	171.6	170.1	1%
L-T Debt	649.7	370.3	130%	780.0	299.5	160%
Total Equity	347.1	315.4	10%	295.0	290.1	2%

\* 1995 by the Center for Financial Research and Analysis (CFRA)

EYDF 036928  
CONFIDENTIAL

**FINDINGS**

- ◆ Operational concerns
- ◆ Aggressive accounting for acquisitions and for startup and related costs
- Weak control environment

**Operational Concerns.** Such concerns, as outlined below, relate to the composition of HEALTHSOUTH's recent growth; the trend toward greater reliance on Medicare revenues; a growing debt burden; and the boost provided by a sale-leaseback transaction.

- **Growth by Acquisition.** Although HEALTHSOUTH's reported revenue for the first nine months of 1994 more-than-doubled (relative to the corresponding prior-year period), this result derived predominantly from the acquisition of National Medical Enterprises, Inc (NME). *While overall revenue grew by 107%, same-store sales increased by merely 10%.*

HEALTHSOUTH's recent mergers and acquisitions, and recently announced planned acquisitions, include the purchase of NME on December 31, 1993, for \$385.1 million; a merger with ReLife, Inc. (NASDAQ:RELF), consummated through an exchange of common stock, on December 27, 1993; the planned purchase, anticipated in mid-April 1995, of Surgical Health Corporation through a planned exchange of common and preferred stock; and the planned purchase, also anticipated in mid-April 1995, of the rehabilitation hospital division of NovaCare, Inc. (NYSE:NOV) for \$235 million.

- **Growing Medicare Concentration, Falling Margins.** HEALTHSOUTH, which derives virtually no profit from either Medicare or Medicaid funded patients, has experienced dramatic growth during the first nine months of 1994 in the proportion of revenues derived from Medicare patients (see Table 1 below)—largely because of the heavy concentration of Medicare revenue acquired from NME (see Table 2 on the following page). As a result, *the Company's net margin for the first nine months plummeted from 7.8% in 1993 to 5.4% in 1994.*

Table 1: Revenue Breakdown

	1994, 9 Months	1993	1992
Medicare	41%	31%	34%
Medicaid	3%	4%	2%
Other	56%	65%	64%

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Table 2: Medicare as a Percentage of Revenue

HEALTHSOUTH, Exclusive of NME-Selected Acquisition	Selected Hospitals Acquired from NME	HEALTHSOUTH, Including Hospitals Acquired from NME
30.6%	49.3%	39.7%

- **Debt Burden.** HEALTHSOUTH experienced an explosion of long-term debt during the final quarter of 1993, primarily as a result of the Company's acquisition strategy. Under the weight of its growing debt load, the Company saw its interest expense, as a percentage of operating income, more-than-double (for the nine-month period ended September 30) between 1993 and 1994. (See Table 3.)

Table 3: Growth in Reported Long-Term Debt, Interest Expense

	9/30/94	12/31/93	9/30/93
Long-Term Debt, Reported	\$850 million	\$780 million	\$370 million
Interest Expense as % of Operating Income <sup>1</sup>	38.6% (9 months)	18.1% (12 months)	18.5% (9 months)

It deserves noting that HEALTHSOUTH's reported long-term debt load is understated by the present value of rent obligations from operating leases (as outlined in the Notes accompanying HEALTHSOUTH's financial statements). Table 4 adjusts certain long-term debt calculations (using conservative assumptions) to incorporate this effect.<sup>2</sup>

The Table shows long-term debt in comparison to both total and tangible assets. The latter calculation removes the effect of goodwill and other intangible assets, which jumped during the first nine months of 1994 by 46% (reaching 19% of total assets), in the wake of the NME acquisition.

Table 4: Adjustments to Long-Term Debt Calculations (at 9/30/94), Based on Operating Lease Obligations

	Reported	CFRA-Adjusted
L-T Debt / Equity	2.45	2.93
L-T Debt / Total Assets	0.63	0.76
L-T Debt / Tangible Assets	0.78	0.94

<sup>1</sup> Operating income for 1993 is adjusted by excluding the operating expense for the NME acquisition.

<sup>2</sup> but not adjusting for the effect of the Company's sale-leaseback transaction in June 1994

- **Beneficial Effects on Reported Financial Condition from Sale-Leaseback Transaction.** HEALTHSOUTH received a cash infusion of \$49 million in June 1994 from Capstone Capital Corporation, as part of a sale-leaseback (SLB) transaction for certain properties. HEALTHSOUTH not only recorded the debt from this transaction off the books, but also realized an \$8 million gain, which will be available in future periods to boost the Company's reported earnings (and thus to offset somewhat the deleterious effect on HEALTHSOUTH's net margin of the NME acquisition).

**Aggressive Accounting for Acquisitions and for Startup and Related Costs.** As outlined below, we feel that HEALTHSOUTH has adopted an aggressive approach in accounting both for acquisitions and for organization, partnership formation, and startup costs.

- **Accounting for Acquisitions.** Immediately after acquiring NME on the last day of 1993, HEALTHSOUTH wrote off 13% of the purchase price (amounting to \$49.7 million). We would question the motive of any company that takes a large write-off in the immediate aftermath of an acquisition. Assuming that HEALTHSOUTH paid what it considers a fair price for the acquired assets, then the entire amount of the purchase price should remain on the Company's balance sheet. If it considered certain asset accounts over-valued, then it should have reallocated dollars into other asset accounts—whether tangible or intangible. *By writing off \$49.7 million on the date of the acquisition, however, HEALTHSOUTH gives the appearance of "clearing the decks" of expenses that would otherwise have to be charged in future periods against operating income.* The Company thus appears to have taken a step to improve its reported profitability in those future periods. We therefore warn that future operating results may have to be interpreted in this light.
- **Accounting for Startup and Related Costs.** HEALTHSOUTH capitalizes organization, partnership formation, and startup costs, and subsequently amortizes such costs over three years. The balance of capitalized costs in this account, before amortization, totalled \$77.9 million at year-end 1994—an increase of \$81.5 million from the prior year. *We feel that such costs should be expensed as incurred, since they appear to constitute ordinary, recurring operating expenses.*

**Weak Control Environment.** In general, we feel that the outside members of a public company's Board of Directors should lack any significant affiliation with either the company, its executive officers, or the other Board members outside of their service as directors and their ownership stake in the Company. We also advocate that the Board should be comprised of individuals with a diverse set of experiences and perspectives. Furthermore, we feel that a public company should avoid engaging in any significant related-party transactions with either its directors or officers, or with any relatives of such directors or officers. As outlined below, HEALTHSOUTH's Board appears lacking with regard to such criteria.

- **Affiliated Members on the Board and on Audit and Compensation Committee.** Three of the five outside directors on HEALTHSOUTH's Board (George H. Strong, C. Sage Givens, and John S. Chamberlin) serve as directors of Curaflex Health Services, Inc.—for which HEALTHSOUTH Chairman and CEO Richard M. Scrushy also serves as a director. One of the other outside directors, Charles M. Newhall III, serves with Mr. Scrushy as a director of Integrated Health Services, Inc. Only one outside director, Dr. Phillip C. Watkins, appears to lack any such affiliation with Mr. Scrushy.

Messrs. Strong and Givens serve, along with Dr. Watkins, as members of the Audit and Compensation Committee. We are also troubled that this committee, which combines two of the most critical and sensitive corporate oversight functions (and which public companies usually split into two separate committees), met on only a single occasion in 1993 (the last full year for which the Company reported in this area).

**Lack of Diversity on the Board.** Three of the five outside directors (Messrs. Strong, Givens, and Newhall) have been described by HEALTHSOUTH as serving for their principal occupation either as a private investor or as the general partner of a venture capital business.

**Generous CEO Compensation.** Mr. Scrusby's 1993 compensation included \$2.72 million in salary and bonus; stock option grants worth an estimated \$2.64 million; and a windfall gain, which CFRA estimates as worth more than \$3 million, resulting from the downward revision of the exercise price of previously granted stock options. His 1994 compensation amounted to \$3.2 million in salary plus bonus. Altogether, Mr. Scrusby held over \$30 million worth of exercisable in-the-money options at year-end 1993 and nearly \$62 million at year-end 1994.

Incidentally, the Board of Directors reported that it had "determined that [the aforementioned repricing of options] was appropriate in light of the decline in the Company's stock price relating to the generally-depressed state of healthcare stocks in early 1993 and the uncertainties surrounding healthcare policy during 1993."<sup>3</sup> CFRA postulates, however, that the Board is unlikely to reprice such options upward in the event that these two conditions abate.

On a more sober note, we would argue that the willingness of a company to engage in the wholesale repricing of options granted to its CEO and other executive officers in effect allows such officers to "have their cake and eat it too." Options are generally viewed as *at-risk* compensation. If companies compensate for unfavorable stock price movements, the down-side of the at-risk component has been neutralized—while the up-side has been expanded. We consider such an approach a clear transfer of wealth to executive option-holders from other Company shareholders. While transfers of wealth may sometimes be justifiable as a means of providing officers with suitable rewards for past efforts or incentives for future service, we feel that they should be formulated and reported on in a significantly more transparent manner—i.e., through either salary, bonuses, or new stock option grants—the value of any of which would be explicitly reported in the annual Proxy Statement.

It also deserves noting that HEALTHSOUTH had planned last year to implement a new, more generous executive stock option plan—but suffered the indignity of seeing the proposal voted down at a shareholder meeting in December 1994. While we consider it encouraging that stockholders took this bold step in preventing what they considered an unwarranted transfer of investors' future wealth into certain executive officer pockets, we are nevertheless troubled by HEALTHSOUTH's attempt to implement a plan that institutional investors (who reportedly led the charge against the stock option plan) would consider out of bounds.

<sup>3</sup> 1993 Proxy Statement

Nov-18-93 04:34pm From:House Energy & Commerce Cmte Ford 202-226-2447 T-561 P.009/010 F-660  
 SENT BY:ERNST & YOUNG LLP ; 3-29-93 12:21PM ;

**Relationship with Capstone Capital.** Between June 23 and September 26, 1994, the Company engaged in roughly \$50 million worth of sale-leaseback transactions with Capstone Capital Corp., a REIT established by Mr. Scrusby for the purpose of investing in ancillary hospital facilities adjacent or physically attached to acute-care hospitals. ✓

**Additional Related-Party Transactions.** HEALTHSOUTH engaged in several significant related-party transactions during 1993 (the last full year for which the Company reported in this area), including the following: ✓

- The Company paid \$3.9 million for computer equipment to GC Enterprises, a value-added reseller owned by Mr. Scrusby's mother.
- The Company paid \$503,047 to Caretenders Health Corp., a home healthcare services provider for which Mr. Scrusby and HEALTHSOUTH Senior Vice President Michael D. Martin formerly served as directors. At year-end 1993, the Company guaranteed \$6 million on a line of credit for Caretenders, in exchange for which Caretenders provided HEALTHSOUTH with warrants to purchase 500,000 shares of Caretenders common stock.
- The Company paid \$284,300 for management services rendered to certain physician practices owned by HEALTHSOUTH to MedPartners, Inc. HEALTHSOUTH director and executive officer Larry R. House (President of HEALTHSOUTH International, Inc. and New Business Ventures) is Chairman and CEO of MedPartners; and Mr. Scrusby is a director of MedPartners (with a 10.5% ownership stake as of March 1994).

**Loans to Officers.** At year-end 1993, the Company had outstanding loans of \$414,000 to Mr. House and \$400,000 to Executive Vice President and CFO and director Aaron Beam, Jr. ✓

HEALTHSOUTH Corp. (3/9/95)  
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6

EYDF 035933  
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**HEALTHSOUTH Corp.**  
**Schedule of Cash Flows**  
**1994 Fiscal Year-End: 12/31/94**

	1994	1993	1992
<b>Inflows (\$ thousands)</b>			
Operations	132,050	59,787	39,192
Proceeds from Sale of Marketable Secur.	1,660	20,554	14,041
Proceeds from Sale of Prop., Plant, & Equip.	59,025	0	0
Changes in Other Assets	0	0	1,834
Proceeds from Borrowings	550,084	512,710	169,800
Proceeds from Exercise of Options	13,895	1,736	6,788
Proceeds from Stock Issuance	533	0	19,004
Other	1,499	1,061	1,329
<b>Total Inflows</b>	<b>756,746</b>	<b>595,848</b>	<b>251,988</b>

<b>Outflows (\$ thousands)</b>			
Purchase of Prop., Plant, & Equip.	123,575	113,161	88,503
Additions to Intangible Assets	59,307	39,156	25,205
Net Assets Acquired through Acquisitions	85,967	420,307	53,961
Changes in Other Assets	17,526	4,846	0
Investments in Marketable Securities	9,126	6,000	13,000
Principal Payments on Debt & Leases	462,481	17,731	61,313
Loans to Empl. Stock Option Plan	0	0	10,000
Transactions Related to Limited Partners	3,146	4,681	14,329
<b>Total Outflows</b>	<b>761,128</b>	<b>613,882</b>	<b>266,311</b>

<b>Inflows (Percentage of Total)</b>			
Operations	17.40%	10.03%	15.55%
Proceeds from Sale of Marketable Secur.	0.22%	3.45%	5.57%
Proceeds from Sale of Prop., Plant, & Equip.	7.78%	0.00%	0.00%
Changes in Other Assets	0.00%	0.00%	0.73%
Proceeds from Borrowings	72.50%	86.05%	67.36%
Proceeds from Exercise of Options	1.83%	0.29%	2.69%
Proceeds from Stock Issuance	0.07%	0.00%	7.54%
Other	0.20%	0.18%	0.53%
<b>Total Inflows</b>	<b>100.00%</b>	<b>100.00%</b>	<b>100.00%</b>

<b>Outflows (Percentage of Total)</b>			
Purchase of Prop., Plant, & Equip.	16.24%	18.43%	33.23%
Additions to Intangible Assets	7.79%	6.38%	9.46%
Net Assets Acquired through Acquisitions	11.29%	69.77%	20.26%
Changes in Other Assets	2.30%	0.79%	0.00%
Investments in Marketable Securities	1.20%	0.98%	4.88%
Principal Payments on Debt & Leases	60.76%	2.89%	23.02%
Loans to Empl. Stock Option Plan	0.00%	0.00%	3.76%
Transactions Related to Limited Partners	0.41%	0.76%	5.38%
<b>Total Outflows</b>	<b>100.00%</b>	<b>100.00%</b>	<b>100.00%</b>

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 **ERNST & YOUNG LLP**

■ AmSouth/Harbert Plaza  
Suite 1900  
1901 Sixth Avenue North  
Birmingham, Alabama 35203

■ Phone: 205 251 2000

March 25, 1997

Tab 70

HEALTHSOUTH Corporation  
One HealthSouth Parkway  
Birmingham, Alabama 35243

Attention: Aaron Beam

Dear Mr. Beam:

Per your request, we are pleased to submit this letter to confirm the scope and fee arrangements for our services related to the 1997 HEALTHSOUTH Pristine Audits.

The details of the Pristine Audits for 1997 will be consistent with those outlined in the section "Details of Quality Standards Program" per the original engagement letter dated February 14, 1996 (see attached) with the following exceptions:

1. All completed checklist will be electronically submitted to the Company within two business days of completion of the audit.
2. The anticipated starting date for the 1997 Pristine Audits is May 1, 1997.
3. The Pristine audits are intended to provide 100% coverage of all HEALTHSOUTH facilities during 1997. In addition, reaudits will be performed at 25% of the Company's facilities (compared to 10% in 1996). The scope as outlined in this paragraph results in an approximate 60% increase in the total number of Pristine Audits to be performed in 1997 as compared to 1996.

We estimate our fees for these services will be \$750,000 plus expenses. If the scope of the reaudits is increased from 25% to 50%, and thereby doubling the number of 1997 Pristine Audits over 1996, the estimated fees would increase by \$150,000 for a total fee of \$900,000, plus expenses. We will submit our invoices at the beginning of each reporting period, and payment of them will be due upon receipt. Ernst & Young will

**ERNST & YOUNG LLP**

Mr. Aaron Beam

Page 2  
March 25, 1997

absorb the cost of professional hours associated with the one-day training program in Birmingham on April 23, 1997, while the travel expenses will be paid by the Company. If additional work should be required because of circumstances not known to us at this time, or that arise during the engagement, we will discuss the circumstances with you at that time before extending the scope of this project.

If these arrangements are acceptable, please sign this letter and return it to us.

We very much appreciate the opportunity to serve HEALTHSOUTH Corporation and would be pleased to furnish any additional information you may request concerning our responsibility and functions.

Very truly yours,

*Richard L. Dandurand*  
Richard L. Dandurand  
Partner

HEALTHSOUTH Corporation

By: *Aaron Beam*  
Aaron Beam  
Chief Financial Officer

*4/22/97*  
Date

1998 <sup>of the</sup> PRISTINE  
DRAFT

March 25, 1998

Tab 71

Mrs. Teresa Sanders  
Group Vice President, Internal Audit  
HEALTHSOUTH Corporation  
One HealthSouth Parkway  
Birmingham, Alabama 35243

Dear Mrs. Sanders:

Per your request, we are pleased to submit this letter to confirm the scope and fee arrangements for our services related to the 1998 HEALTHSOUTH Pristine Audits.

The details of the Pristine Audits for 1998 will be consistent with those outlined in the section "Details of Quality Standards Program" per the original engagement letter dated February 14, 1996 (see attached) with the following exceptions:

1. The anticipated starting date for the 1998 Pristine Audits is May 1, 1998.
2. The 1998 Pristine Audit checklist will be expanded to include procedures covering corporate compliance issues. We have estimated that these procedures will add one hour to each of the individual site visits.  
*your not at facility only passing out checklist or corp compliance*
3. The Pristine audits are intended to provide 100% coverage of all HEALTHSOUTH facilities during 1998. In addition, reaudits will be performed at 25% of the Company's facilities.  
*your will be taking audits tracking return*
4. The scope as outlined in this paragraph results in an approximate 45% increase in the total number of Pristine Audits to be performed in 1998 as compared to 1997. Total sites visited in 1997 was 1,269 compared to a planned 1,988 this year

We estimate our fees for these services will be \$1,250,000 plus expenses. If the scope of the reaudits is increased from 25% to 50%, the estimated fees would increase by \$260,000 for a total fee of \$1,510,000, plus expenses. We will submit our invoices at the

Mr. Teresa Sanders

Page 2  
March 25, 1997

*try to  
over hotel cost  
the part  
airfare*

beginning of each reporting period, and payment of them will be due upon receipt. Ernst & Young will absorb the cost of professional hours associated with the two-day training program in Birmingham on April 20th and 21st, while the travel expenses will be paid by the Company. If additional work should be required because of circumstances not known to us at this time, or that arise during the engagement, we will discuss the circumstances with you at that time before extending the scope of this project.

If these arrangements are acceptable, please sign this letter and return it to us.

We very much appreciate the opportunity to serve HEALTHSOUTH Corporation and would be pleased to furnish any additional information you may request concerning our responsibility and functions.

Very truly yours,

Richard L. Dandurand  
Partner

HEALTHSOUTH Corporation

By: \_\_\_\_\_

Title: \_\_\_\_\_

\_\_\_\_\_ Date

NOV-11-89 17:58 FROM: ERNST & YOUNG LLP

ID: 212 773 1800  
 (copy to Tom Milan) PAGE 1/1

*HealthSouth*

*gpc 11/10/89*

Tab 72

Post-It Fax Note	7571	Date	11/10/89	Page	1
To	Jim Conway	From	E&Y		
Co./Dept		CA			
Phone #		Phone #			
Fax #	404-877-4292	Fax #			

TO: List  
 FROM: Fleecead Shareholder  
 RE: Healthsouth/Ernst & Young

You bring the smoke, I'll bring the mirrors. At least the market has shown the wisdom to devalue HS stock. Wish I got out in time. I have a list of questions, which I hope might interest you.

How can the HS outpatient clinics treat patients without precertification, book the revenue, and carry it after being denied payment ?

How can the company carry tens of millions of dollars in accounts receivable that are well over 90 days ?

How can some hospitals have NO bad debt reserves ?

How did the E&Y auditors in Alabama miss this stuff ?

Are these clever tricks to pump up the numbers, or something that a novice accountant could catch ?

How is it that a year ago Vencor announced that the BBA would have a major impact on its Tefra reimbursement, but HS management, similarly affected by BBA cutbacks in all divisions, was mute? They were busy though, cashing out before the big hit.

Does anyone really believe that nonsense about managed care pressure? It's the Medicare, stupid.

If the accounting is slick, what do the cost reports look like ?

You people and I have been hoodwinked. This note is all that I can do about it. You all can do much more, if all you do is look into it to see if what I say is true.

Distribution:

- Barry Melancon, AICPA
- Phil Laskaway, Ernst & Young
- Nancy Ann Mir De Paula, HCFA
- Steve Jones, Business Week
- D. Scott Mackesy, Morgan Stanley
- Darren Robbins, Wilberg Weiss
- SEC Division of enforcement



One HealthSouth Parkway  
Birmingham, AL 35243

**MEMORANDUM**

**TO:** William W. Horton

Tab 73

**FROM:** William T. Owens

**DATE:** December 10, 1998

**SUBJECT:** Ernst & Young Correspondence

As you directed in your memo dated November 11, 1998, I have completed a detailed review of the matters raised in the anonymous correspondence sent to Ernst & Young. My findings are as follows:

1. Outpatient Centers' Precertification.

I asked Teresa Sanders to recap the Internal Audit reports of all reviews performed during 1996, 1997 and 1998. Her report is attached. During 1996, Internal Audit visited 18 outpatient centers and audited 270 patient records, finding only 2.6% of those records to not include the insurance verification form. During 1997, they visited 22 centers and audited 225 patient records, finding only 3.1% of those records to not include the insurance verification form. The 1998 audit results will be completed later this month.

2. Accounts receivable over 360 days.

At September 30, 1998, the Company's four primary operating divisions had total gross accounts receivable of approximately \$1.42 billion. Included in that total were \$181.9 million in accounts over 365 days old. Approximately \$122 million of the over 365 day accounts come from the Outpatient Rehab and Diagnostic divisions, both of which have Regional Business Offices. Operations has recently determined that the management of the RBO's was not adequate and has taken actions to improve their operations. I believe that our accounts receivable are adequately reserved and fairly stated.

\_hsmemo.dot

{SAVEDATE \@\*M/d/y}\*MERGEFORMAT}

10/13/2003

**HHEC 678-0192**  
Confidential Treatment  
Requested by HealthSouth Corp.

0532209



One HealthSouth Parkway  
Birmingham, AL 35243

3. Hospitals with no Bad Debt Expense.

Attached you will find schedules with show the percentage of contractual adjustments to gross revenue and the percentage of bad debt expense to non-Medicare and non-Medicaid revenue for 1996, 1997 and YTD 1998. This schedule shows that all facilities have contractual adjustments recorded in each period and only isolated occurrences of no bad debt expense or negative bad expense (16 occurrences in 286 periods presented).

If you have any questions, call me at extension 4703.

{SAVEDATE \@\*M/d/yy"\"MERGEFORMAT}

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**HHEC 678-0193**

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Requested by HealthSouth Corp.

0532209

10/13/2003

**HEALTHSOUTH** The Pristine Factor. Outpatient Division 1998/1999

Auditor # \_\_\_\_\_ Facility undergoing construction/renovations at the time of audit.  Yes

Date \_\_\_\_/\_\_\_\_/\_\_\_\_

Time \_\_\_\_:\_\_\_\_ AM / PM

Facility Number **04 / 08**

Facility Location (City/State) \_\_\_\_\_ Tab 74

<b>Patient</b>	<b>Exterior of Facility</b>			
	1. Parking area is free of trash. (N/A for facilities leasing space within a building.)	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	2. Entrance to facility is free of trash and debris.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	3. Entrance to building appears in good repair and building supports HEALTHSOUTH image.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	4. Facility has a sign identifying it as a HEALTHSOUTH facility. If no, note reason and when facility was acquired. _____	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
<b>Respect</b>				
	<b>Lobby/Waiting Area</b>			
	5. Overall appearance is organized and neat.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	6. Magazines appear neat and orderly.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	7. Furniture appears in good repair.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
<b>Integrity</b>	8. Chairs/Seating have no stains, lint or broken parts.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	<b>Receptionist</b>			
	9. Patients/Visitors are greeted upon entry.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	10. Receptionist has a friendly and helpful attitude.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	11. Proper telephone etiquette is used.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
<b>Service</b>	12. Work area in patient/visitor view is organized and neat.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	13. "HEALTHSOUTH receipts are issued to all patients making a payment at our facility" sign is displayed at receptionist desk.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	<b>Treatment/Examination Areas</b>			
	Answer items 14, 15 and 16 ONLY if patients are in the facility during the audit.			
<b>Teamwork</b>	14. Staff is attentive to patients.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	15. Staff exhibits a caring and professional attitude toward patients.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	16. Patient privacy is respected at all times.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	17. Carpet or flooring appears clean and in good repair.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	18. Ceiling is free of stains.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	19. Ceiling heating/cooling vents are free of dust accumulation.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
<b>Impression</b>	20. Walls are free of stains and marks. If no, note areas needing attention. _____	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	21. Equipment appears in good working condition.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	22. Equipment has no dust or rust.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	23. Pool/Whirlpool is free of stains.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	24. Facility has adequate lighting.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	25. Doors to storage areas are closed to public view.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
<b>No hassle</b>	26. Music is at a level for holding conversations without raising voices.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	27. CLEAN laundry is neatly folded and stored in a designated area.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
	28. SOILED laundry is stored in a covered container.	<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> N/A
<b>Extra mile</b>				



<b>Patient</b>	<b>Public Restrooms (located inside facility only)</b>		
	29. Floors are free of trash.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	30. Floors, walls and toilet areas are free of stains.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	31. Overall appearance is sanitary.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>Respect</b>	<b>Financial</b>		
	32. Facility is using the "One-Write" system for issuing patient receipts.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>Integrity</b>	33. Over-the-counter collections are stored in a LOCKED safe or cash box overnight until forwarded to RBO/CPC or deposited in the bank. If no, note where money is stored. _____	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	34. Three people or less have a key to cash box or the safe combination. List names and titles: _____	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	35. Throughout facility, assets are tagged with HEALTHSOUTH fixed asset tags. Note one asset description and tag #: _____	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>Service</b>	Obtain patient schedule for ONE business day prior to the audit and select three medical charts for patients treated on that date.		
	36. Procedure(s) is(are) documented for the date under review.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	37. Patient has signed consent to treat form. Note problems with 36 and 37. _____	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>Teamwork</b>	<b>General</b>		
	38. Facility business license is framed and displayed publicly.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	39. Select three personnel files. Evidence of Completion form for Module One is on file. If no, note employee's name and date of hire. _____	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>Impression</b>	40. Throughout facility, all trash receptacles have liners. If no, note location. _____	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	41. Throughout facility, all employees are identified by name/ID badges or HEALTHSOUTH apparel.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	42. There are NO taped signs (handwritten or printed) on walls, doorways or equipment throughout facility.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	43. HEALTHSOUTH merchandise brochure is displayed publicly.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	44. "PULLING THE WAGON" poster is displayed publicly in the facility.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>No hassle</b>	45. "WE'VE ADDED OUR 50TH STATE" poster is displayed publicly in facility.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	46. "INTEGRITY IN ACTION" poster is displayed in area accessible to employees only.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	47. Soda vending machines located in facility distribute Coca-Cola products. (N/A for facilities without vending machines inside the facility.)	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	48. Throughout facility, employee work areas are organized and neat.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	49. Throughout facility, storage areas are organized and neat.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
	50. Overall attitude of the facility is courteous and professional.	<input type="radio"/> Yes	<input type="radio"/> No <input type="radio"/> N/A
<b>Extra mile</b>			





We complete this questionnaire for each of the five components of internal control (i.e., the control environment, the client's risk assessment process, control activities, information and communication, and monitoring processes) for the entity as a whole. In addition, for multilocation engagements, we complete the applicable sections of the questionnaire and make our assessments for those locations (e.g., subsidiaries, divisions) at which we perform full-scope procedures. For example, at a large subsidiary where we perform full-scope procedures, we would prepare/update the questionnaire as it relates to that subsidiary. However, certain sections (e.g., "Board of Directors and/or Audit Committee Participation") may not be applicable and need not be completed. The partner in charge of the audit determines whether some or all of the questionnaire should be completed at locations where we do not perform full-scope procedures. In making this determination, the partner in charge of the audit considers such factors as the materiality of the location; the nature and extent of our procedures at the location; the nature and extent of the location's operations and the similarity of its operations, systems, and procedures to those at other locations; the degree of operating autonomy granted the location; whether the internal auditors have completed (and we have reviewed) a similar questionnaire for the location; our understanding of the business and financial statement risks associated with the location; the client's expectations; and concerns about internal control or fraud resulting from our prior experiences.

The questionnaire should be completed/updated by those on the engagement team with sufficient experience and knowledge of the client to know, with a high degree of confidence, whether the risk factors in the questionnaire are present and whether additional risk factors should be considered. Further, those same individuals ordinarily are involved in making our assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of material misstatement due to fraud.

Because the process of completing/updating the questionnaire frequently will require input from more than one team member, the process ordinarily can be accomplished in a more effective and efficient manner when the engagement team (including the partner) discusses, early in the engagement, which individual(s) will be responsible for completing/updating which sections of the questionnaire. For example, the partner or senior manager (who ordinarily have interaction with the board of directors and/or the audit committee) normally are the only members of the engagement team with sufficient knowledge to respond to the items in the section entitled "Board of Directors and/or Audit Committee Participation," while the manager and senior (when they have worked on the engagement before) ordinarily will have sufficient knowledge of the client and its business to complete/update most of the remainder of the questionnaire, with input as necessary from others on the engagement team.

The first time the ICFC questionnaire is completed (whether for a first-year or recurring audit) the partner in charge of the audit reviews and approves it. In subsequent years, at least a manager reviews and approves the ICFC questionnaire.

Each year, a copy of the "Summary and Conclusions" page(s) of this questionnaire is attached to the Audit Strategies Memorandum.

We also review and update this questionnaire during our annual client continuance process whenever we assess our risk relating to the client as "other than low" on Form U574, "Evaluation of Audit Clients—Risk Assessment." In such situations, we attach a copy of the updated questionnaire to Form U575, "Audit Client Continuance Form."

#### **Risk Factors**

This questionnaire contains lists of risk factors that are relevant to internal control at the entity level and/or the risk of material misstatement due to fraud. However, the lists are not necessarily all inclusive. Based on our understanding of the client and its business and industry, we may identify other risk factors that should be considered and documented in the questionnaire.

The relative importance of the risk factors varies among engagements from critical to insignificant. Some of the factors will be present in clients where the specific conditions do not present a weakness in internal control at the entity level or present a risk of material misstatement due to fraud, while in other situations, they may. Accordingly, we exercise considerable professional judgment when considering the risk factors individually and in combination. When considering the presence of risk factors, we consider whether there are other factors or specific controls that mitigate or exacerbate the risk factors we have identified.

While a "yes" response to a risk factor does not necessarily mean that internal control at the entity level is ineffective or there is a risk of material misstatement due to fraud, a "yes" response (particularly when there are multiple "yes" responses) to a risk factor should heighten our awareness, and we give it (them) due consideration.

In instances where a risk factor is not applicable (e.g., the risk factors related to internal audit may not be applicable in smaller entities), indicate "N/A" in the "No" column for the risk factor.

**Considerations for Smaller Entities**

The relative importance of the factors will vary based on the client's size, complexity, and ownership, among other considerations. For example, a smaller client may not have a written code of conduct, but instead may develop a culture that emphasizes the importance of integrity and ethical behavior through oral communications and by management's example. Similarly, a smaller client may not have an independent or outside member on its board of directors. However, these conditions may not negatively affect our assessment of internal control at the entity level or the risk of material misstatement due to fraud.

**Control Environment**

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. We obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitudes, awareness, and actions concerning the control environment considering both the substance of controls and their collective effects.

The control environment consists of the following elements:

- Management's control consciousness and operating style.
- Integrity and ethical values.
- Board of directors and/or audit committee participation.
- Organizational structure and assignment of authority and responsibility.
- Human resource policies and practices and commitment to competence.

When gaining an understanding of the control environment, we consider each of these elements and their interrelationships. In particular, we recognize that significant deficiencies in any one of the elements may undermine the effectiveness of the others.

***Management's Control Consciousness and Operating Style***

Management's control consciousness and operating style may have a pervasive effect on internal control.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Management is dominated by one or a few individuals without effective oversight by the board of directors or audit committee.	<input checked="" type="checkbox"/> <input type="checkbox"/>	<input type="checkbox"/> <input type="checkbox"/>
• Management lacks a proven track record in this or other businesses.	<input type="checkbox"/> <input type="checkbox"/>	<input checked="" type="checkbox"/> <input type="checkbox"/>
• Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.	<input type="checkbox"/> <input type="checkbox"/>	<input checked="" type="checkbox"/> <input type="checkbox"/>
• Management's excessive interest in maintaining or increasing the client's stock price or earnings trend.	<input checked="" type="checkbox"/> <input type="checkbox"/>	<input type="checkbox"/> <input type="checkbox"/>
• Management's failure to give appropriate attention to internal control, including the effects of information systems processing.	<input type="checkbox"/> <input type="checkbox"/>	<input checked="" type="checkbox"/> <input type="checkbox"/>
• Management's failure to correct known reportable conditions on a timely basis.	<input type="checkbox"/> <input type="checkbox"/>	<input checked="" type="checkbox"/> <input type="checkbox"/>
• Management sets unduly aggressive financial targets and expectations for operating personnel.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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- A significant portion of management's compensation is derived from bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results or financial position.
- Management is aggressive in selecting accounting principles and determining estimates.
- Management commits to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts.
- Management does not consult us on significant matters relating to internal control and accounting issues or there are frequent disputes regarding them (or for initial engagements, there were disputes with the predecessor auditors).
- Management displays a cavalier attitude toward, and inadequate monitoring of, significant business risks.
- Management displays significant disregard for regulatory authorities.
- There is a history of securities law violations or claims against the client or its management alleging fraud or violations of securities laws.
- Management displays significant disregard for the audit.
- Management is domineering in dealing with us.
- Management attempts to reduce the scope of the audit (directly, for example, by limiting access to people or information, or indirectly, for example, by unreasonable fee or time constraints) or imposes unreasonable deadlines.
- Management attempts to limit our ability to communicate effectively with the board of directors or the audit committee.

*Indicate other risk factors considered:*

There is an informal monitoring in place for the allowance setting on A/R. However formal monitoring would mitigate significant business risks.

Factors mitigating the lack of formal monitoring is the testing done by internal audit related to the agings and the fact that senior management does analyze the reserves on an ongoing basis.

See additional risks associated with the internal audit function.

***Integrity and Ethical Values***

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of the other components of internal

control. Integrity and ethical behavior are the product of the client's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Lack of policies regarding the client's values and behavioral standards and lack of codes of conduct.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Ineffective means of communicating and supporting the client's values or ethics.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not attempt to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not lead by example.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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*Indicate other risk factors considered:*

**Board of Directors and/or Audit Committee Participation**

The client's control consciousness is influenced significantly by the board of directors and/or audit committee.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Board of directors does not have a charter or objectives for the audit committee.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate communications among the board, audit committee, and external and internal auditors.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Audit committee members are not appropriately experienced or qualified.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors or audit committee is not sufficiently independent of management.	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate number of meetings or the matters discussed are not appropriate.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors and audit committee do not adequately scrutinize activities—difficult questions are not raised and pursued with management.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors and audit committee are not adequately involved in the financial reporting process.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High turnover of board members.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

Board contains five of thirteen members of management, but the audit committee is independent of management.

**Organizational Structure and Assignment of Authority and Responsibility**

The client's organizational structure provides the framework within which its activities for achieving entitywide objectives are planned, executed, controlled, and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The client should have an organizational structure that is suited to its needs. The appropriateness of the client's organizational structure depends, in part, on its size and the nature of its activities. The assignment of authority and responsibility pertains to how operating activities are

assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of appropriate management oversight (for example, inadequate supervision or monitoring of information systems or remote locations).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• A poor structure for assigning ownership of data, including who is authorized to initiate and/or change transactions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Difficulty in determining the organization or individual(s) that control(s) the client.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High turnover of senior management or legal counsel.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of appropriate system of authorization and approval of transactions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Unclear assignment of responsibilities, including those specific to information systems processing and program development.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Policies and procedures for the authorization of transactions are not established at the appropriate level.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

***Human Resource Policies and Practices and Commitment to Competence***

Human resource policies and practices relate to hiring, orienting, training, evaluating, counseling, promoting, compensating, and taking remedial actions. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
--	------------	-----------

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inadequate standards and procedures for hiring, training, motivating, evaluating, promoting, compensating, transferring, or terminating personnel in some or all functional areas (e.g., accounting, marketing, information systems).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• No written job descriptions or reference manuals that inform personnel of their duties.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate procedures for establishing and communicating policies and procedures to personnel at decentralized locations (including foreign operations).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Employees with access to cash, securities, and other valuable assets are not bonded.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Policies and procedures are not clear or issued, updated, or revised timely.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of mandatory vacation policy for employees performing key control functions.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Anticipated future employee layoffs that are known to the work force.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Employees with access to assets susceptible to misappropriation who are known to be dissatisfied.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Known unusual changes in behavior or lifestyle of employees with access to assets susceptible to misappropriation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Known personal financial pressures affecting employees with access to assets susceptible to misappropriation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

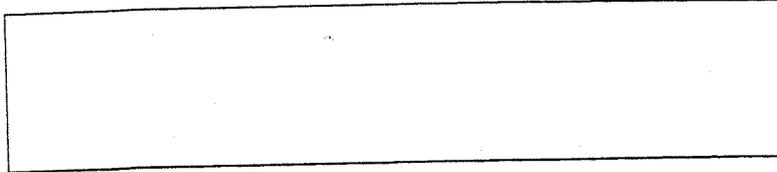
*Indicate other risk factors considered:*

All employees go through FACIS screening.

***Comments and Additional Information***

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of material misstatement due to fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

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### The Client's Risk Assessment Process

Risk assessment is the *client's* process for identifying and analyzing the risks (both internal and external) that are relevant to the achievement of its objectives. In addition, a risk assessment process provides the client with a basis for determining how to manage its risks (e.g., the actions to address specific risks or a decision to accept a risk because of cost or other considerations). After indicating the risk factors in this section that we are aware of that are present, we gain an understanding of the client's risk assessment process, specifically as it relates to the financial reporting objectives of internal control, and then we determine, generally through inquiry, observation, and inspection of relevant documents, whether the client's risk assessment process has identified and analyzed each of the risks, and if so, whether the client has implemented appropriate steps to mitigate each of the risks.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
<b>Business and Industry</b>		
• High degree of competition or market saturation, accompanied by declining margins.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Declining industry with increasing business failures.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Rapid changes in the industry, such as significant declines in customer demand, high vulnerability to rapidly changing technology or rapid product obsolescence.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Unusually rapid growth or unusually high profitability, especially compared with those of other companies in the same industry.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<b>Operations</b>		
• Changes in the entity's operating environment.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• New personnel in key financial or operating positions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• New or revamped information systems.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant new lines, products, or activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Unrealistically aggressive sales or profitability incentive programs.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High levels of sales returns.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Corporate restructuring.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Especially high vulnerability to changes in interest rates.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant operations in countries where business practices are questionable.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Small number of transactions that have a material effect on the client.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Assets susceptible to misappropriation; such as large amounts of cash or assets easily convertible into cash; goods in inventory are small in size, high in value, or high in demand; fixed assets are small, marketable, or lack ownership identification.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
<b>Financial Condition</b>		
• Inability to generate cash flows from operations while reporting earnings and earnings growth.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Operating losses or significant deterioration in earnings.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Marginal ability to meet debt repayment requirements (or comply with restrictive loan covenants).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Ability to raise additional capital is limited (e.g., due to high leverage or an inadequate capital base).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Severely deteriorating financial condition or liquidity, or threat of imminent bankruptcy or foreclosure (including when management has personally guaranteed significant debts of the client or when the most recent audit report included, or serious consideration was given to including, a disclaimer or an explanatory paragraph describing an uncertainty about the client's ability to continue as a going concern).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<b>Accounting</b>		
• Assets, liabilities, revenues, or expenses are based on significant estimates that involve unusually subjective judgments or uncertainties (e.g., the timing of revenue recognition or the capitalization of costs), or that are subject to potential significant changes in the near term in a manner that may have a financially disruptive effect on the client.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant, unusual, or highly complex transactions or innovative deals (especially those close to year end) that make the determination of their effects on the financial statements difficult or highly subjective or pose difficult "substance over form" questions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• An extraordinary volume of shipments shortly before or at year end or quarter ends.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the client.	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
• Public criticism or litigation involving accounting, financial reporting, or business practices of the client or of companies in one or more of its industries.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Restatement of the prior year's financial statements for the correction of an error.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Adverse consequences on significant pending transactions, such as a business combination, planned debt or equity issue, or contract award, if poor financial results are reported.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<b>Related Parties</b>		

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*Are the following risk factors present?*

- |  | <u>Yes</u>               | <u>No</u>                           |
|--|--------------------------|-------------------------------------|
| • Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm. | <input type="checkbox"/> | <input checked="" type="checkbox"/> |
| • Other auditors involved with related entities (or in the annual audit), or some related entities not audited.                                  | <input type="checkbox"/> | <input checked="" type="checkbox"/> |

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*Indicate other risk factors considered:*

HealthSouth has a variable rate line of credit.

HRC's stock price limits their ability to sell treasury stock.

BBA was the driving force in HRC's decision to abandon home health. Future ramifications are unknown.

Class action suits ongoing.

Does the client have a formal risk assessment process? Yes  No . If not, does the client have an informal risk assessment process? Yes  No .

Briefly describe the client's risk assessment process, specifically as it relates to the financial reporting objective of internal control (i.e., preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles):

Corporate Compliance program has been initiated enterprise wide. Brad Hale is the Compliance Officer.  
Company prepares budgets and compares to actual. They have weekly meetings regarding financial results at the facility level.  
Internal audit performs procedures throughout the year and reports directly to the audit committee.

With respect to the risk factors identified above, has the client's risk assessment process:

- Identified and analyzed each of the risks? Yes  No .
- If yes, has the client implemented appropriate steps to mitigate each of the risks? Yes  No .

**Comments and Additional Information**

Provide additional information about the identified risk factors (and the effectiveness of the client's risk assessment process in addressing and mitigating each of them) to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of material misstatement due to fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

**Control Activities and Information and Communication**

Control activities are the policies and procedures that help ensure that management's directives are carried out. The information system, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inability to prepare accurate and timely financial reports, including interim reports.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Planning and reporting systems (such as business planning; budgeting, forecasting, and profit planning; and responsibility accounting) that do not adequately set forth management's plans and the results of actual performance.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate methods of identifying and communicating exceptions and variances from planned performance.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management's response to reported exceptions and variances is inadequate.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• A low level of user satisfaction with information systems processing, including reliability and timeliness of on-line and hard-copy reports.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate policies for developing and modifying accounting systems and controls, including changes to and use of computer programs and/or data files.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Overall lack of coordination between the accounting and data processing functions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Understaffed accounting or information technology department, inexperienced or ineffective accounting or information technology personnel, or high turnover.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Lack of timely and appropriate documentation for transactions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Accounting system is in disarray.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

Ken Livesay moved from Asst. Controller to CIO. This should improve the communication between ITG and Accg.

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***Comments and Additional Information***

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of material misstatement due to fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

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**Monitoring**

Monitoring is the process that assesses the quality of the performance of internal control over time.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inadequate monitoring of the continued functioning of significant controls.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Reportable conditions/material weaknesses in internal control (especially when management does not correct them promptly).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Control-related recommendations from internal and/or external auditors are ignored.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High level of customer complaints (especially when management does not fix the cause of them promptly).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Owner/manager not actively involved in the business.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant minority owners (e.g., venture capitalists) and creditors (e.g., banks) do not adequately scrutinize activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Parent company does not adequately scrutinize activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Oversight by applicable legislative or regulatory bodies, such as examinations by bank regulatory agencies, is ineffective.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<i>If the client does not have an internal audit function, check here <input type="checkbox"/>, skip the remaining risk factors in this section and consider whether the absence of an internal audit function constitutes a risk factor.</i>		
• Internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• The scope of internal audit's activities is not appropriate (e.g., balance between financial and operational audits, coverage and rotation of decentralized operations).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit has limited authority to examine all aspects of the client's operations or fails to exercise its authority.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit does not adequately plan, perform risk assessments, or document the work performed or conclusions reached.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Internal audit does not adhere to professional standards.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Internal audit has operating responsibilities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

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*Comments and Additional Information*

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of material misstatement due to fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

--

**Fraud Inquiries**

Comment below on your findings from your inquiries of selected members of management regarding (1) their understanding of the risk of fraud in the entity, and (2) whether or not they have knowledge of any fraud (other than that which is "clearly inconsequential") that has been perpetrated on or within the entity (these inquiries of management are to be made during the early planning stages of the audit by at least a manager):

*Management's understanding of the risk of fraud:*

[Indicate the name(s) and level(s) of the members of management with whom the discussions were held as well as the bases for their responses (e.g., what processes do they employ to provide them with reasonable assurance that their risk assessments are appropriate).]

HRC has a Corporate Compliance Program that includes training for all HRC management, employees and the Board of Directors. Inquiries were made of Tony Tanner, Corporate Secretary and Compliance Officer.

*Management's knowledge of fraud:*

[Indicate the name(s) and level(s) of the members of management with whom the discussions were held as well as the bases for their responses (e.g., what processes do they employ to provide them with reasonable assurance that there are no significant instances of fraud other than those they may have mentioned).]

Inquiries were made of Tony Tanner and Bill Owens, Corporate Controller. They indicated they were not aware of any significant instances of fraud. A few isolated billing issues have been reported on the hot line, but follow-up by the Company disclosed the instances were minor and not systematic.

Describe any program (not discussed elsewhere in this questionnaire) that the entity may have in place that includes steps to prevent, deter, and detect fraud. If such a program is in place, ask those persons who oversee such program whether the program has identified any fraud or fraud risk factors.

HRC, with the assistance of E&Y, has implemented an extensive Compliance program. All employees are given Compliance training. The Company has a "hotline" available to employees to report fraud and abuse. The hotline is monitored by internal audit. All reports are reported to the Compliance Officer and investigated.

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**Summary and Conclusions**

**Internal Control and Fraud Considerations**

(To be Attached to the Audit Strategies Memorandum)

With respect to any risk factors we have identified, describe any controls and/or other factors relating to the client and its business and industry that we are aware of that either mitigate or exacerbate the identified risk factors, and describe the resulting effects of the risk factors on our assessments of internal control at the entity level and the risk of material misstatement due to fraud:

HEALTHSOUTH has adopted a corporate compliance program to mitigate any possible government review of billing practices etc.

The majority of the Board is non-management and independent of the company.

The client's internal control at the entity level is  is not  effective. Describe the basis for your conclusion, if it is not obvious:

Describe our audit response(s), if any, to the risk factors we have identified that are not ~~sufficiently~~ fully mitigated by the client's controls or other factors (or our judgment that our planned audit procedures already constitute a sufficient response to the risk factors):

N/A

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**Why the HealthSouth Pristine Audits should not be considered Internal Audit Services.**

The major role of internal audit is to focus on the efficiency and effectiveness of the internal control environment. While the Pristine Audits are an important part of the operational control of the management of HealthSouth facilities it is not a monitoring mechanism for the internal control environment.

HealthSouth determines the Pristine procedures to be performed, the timing of the procedures, the method of reporting, and the communication with executives and the board. Therefore the work that is performed is more like an Agreed-Upon Procedures engagement than any other type of engagement. The only difference being that there is perhaps more judgment involved in executing that Pristine Audit than would be allowed in a true Agreed-Upon Procedures report.

The nature of the focus of the pristine audit is much more operational than financial. In fact very few of the checklist items deal with financial matters. Operational auditing was not included in the SEC restrictions on Internal Audit Services and is not considered to be part of the current public debate.

The administration of the HealthSouth Pristine Audits is conducted not by the Internal Audit Department but by the Corporate Compliance Department.

Tab 76

**Internal Control and Fraud Considerations**

Tab 77

Client HEALTHSOUTH Corporation

Subsidiary or Division \_\_\_\_\_

Audit Date 12/31/01

Completed or Updated by	Date	Reviewed and Approved by	Date
See AWS		See AWS	

**General**

This questionnaire assists us in gaining an understanding of and assessing internal control at the entity level and in assessing the risk of fraud. This questionnaire provides us with only a portion of the understanding about an entity's internal control that we are required to obtain to plan the audit (e.g., make our preliminary combined inherent and control risk assessments) and to determine the nature, timing, and extent of our audit procedures. We also are required to obtain information about internal control at the individual application/process level.

This questionnaire has been designed to be completed/updated electronically or manually. To complete/update the questionnaire electronically, click in the appropriate box to the right of the risk factor. Clicking in the box will enter an "X," clicking again will remove the "X."



Indicate other risk factors considered:

**Management's Control Consciousness and Operating Style**

Management's control consciousness and operating style have a pervasive effect on internal control.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Management is dominated by one or a few individuals without effective oversight by the board of directors or audit committee.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Management lacks a proven track record in this or other businesses.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management's excessive interest in maintaining or increasing the client's stock price or earnings trend.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Management's failure to give appropriate attention to internal control, including the effects of information systems processing.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management's failure to correct known reportable conditions on a timely basis.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management sets unduly aggressive financial targets and expectations for operating personnel.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• A significant portion of management's compensation is derived from bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results or financial position.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management is aggressive in selecting accounting principles and determining estimates.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management commits to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not consult us on significant matters relating to internal control and accounting issues or there are frequent disputes regarding them (or for initial engagements, there were disputes with the predecessor auditors).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management displays a cavalier attitude toward, and inadequate monitoring of, significant business risks.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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### Monitoring

Monitoring is the process that assesses the quality of the performance of internal control over time. An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and whether they are modified as appropriate for changes in conditions.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inadequate monitoring of the continued functioning of significant controls.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Reportable conditions/material weaknesses in internal control (especially when management does not correct them promptly).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Control-related recommendations from internal and/or external auditors are ignored.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High level of customer complaints (especially when management does not fix the cause of them promptly).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Owner/manager not actively involved in the business.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant minority owners (e.g., venture capitalists) and creditors (e.g., banks) do not adequately scrutinize activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Parent company does not adequately scrutinize activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Oversight by applicable legislative or regulatory bodies, such as examinations by bank regulatory agencies, is ineffective.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<i>If the client does not have an internal audit function, check here <input type="checkbox"/>, skip the remaining risk factors in this section and consider whether the absence of an internal audit function constitutes a risk factor.</i>		
• Internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• The scope of internal audit's activities is not appropriate (e.g., balance between financial and operational audits, coverage and rotation of decentralized operations).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit has limited authority to examine all aspects of the client's operations or fails to exercise its authority.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit does not adequately plan, perform risk assessments, or document the work performed or conclusions reached.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Internal audit does not adhere to professional standards.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Internal audit has operating responsibilities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Comments and Additional Information*

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

--

HealthSouth

Conference call w/

Bill Owens (CFO) + George Strong

7/26/02 4:00

- Bill led discussion, informed G.S. of facts, discussed results of their review, our review, findings, etc.
- Also discussed employee who made allegations
- Discussed specific accts. that were name, discussed procedures for reviewing capital items and expenses
- GS satisfied we had done enough (co. + sy) to put an end to "review"
- Also, decided to communicate w/ <sup>X</sup> employee and let him know we had follow-up on his concerns and found nothing of any concern.

written by Bill + George

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Prepared by

Index No.

(262)

J

1

Curtis W. Miller To: James P. Lamphron/Southeast/AUDIT/EYLLP/US@EY-NAmerica  
07/01/2002 10:32 AM cc:  
Subject: \*EY.COM REQUEST\* HealthSouth Corporation (July 1, 2002)

----- Forwarded by Curtis W. Miller/Southeast/AUDIT/EYLLP/US on 07/01/2002 10:29 AM -----

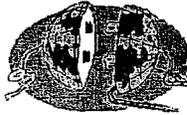


Victoria L. Motes To: Chris L. Abston/SWPacific/AUDIT/EYLLP/US@EY-NAmerica, Curtis W.  
07/01/2002 10:08 AM Miller/Southeast/AUDIT/EYLLP/US@EY-NAmerica  
cc:  
Subject: \*EY.COM REQUEST\* HealthSouth Corporation (July 1, 2002)

As an FYI...

Submitted (June 30, 2002) through the global ey.com site, the following comments pertain to HealthSouth Corporation.

Regards,  
Vicky Motes



Victoria L. Motes  
Global Assurance & AABS Infrastructure  
1300 Huntington Building, 925 Euclid Ave., Cleveland, OH 44115-1405  
Telephone: (216) 583-4553, EY/COMM: 2486683, E-mail: victoria.motes@ey.com  
Communications Professional/US AABS Practice Internet Web Steward

----- Forwarded by Victoria L. Motes/National/AUDIT/EYLLP/US on 07/01/2002 11:03 AM -----



Webmaster To: Victoria L. Motes/National/AUDIT/EYLLP/US@EY-NAmerica  
07/01/2002 09:56 AM cc:  
Subject: Re:

----- Forwarded by Webmaster/EY-APP/US on 07/01/2002 10:02 AM -----

From: Cecile Le Moigne@EYI-EMEA on 07/01/2002 07:50 AM GDT  
To: Webmaster/EY-APP/US@EY-NAmerica  
cc:  
Subject: Re:

Michaelvines302@cs.com



Michaelvines302@cs.com To: eyi.webmaster@marketing.eyi.uk.eyi.com  
om cc:  
30/06/2002 22:53 Subject:

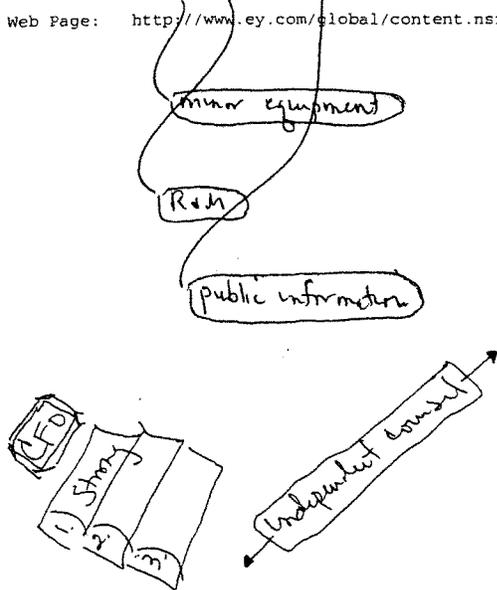
To: eyi.webmaster@marketing.eyi.uk.eyi.com

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From: Mike Vines  
E-mail: Michaelvines302@cs.com  
Title: Other  
Company:  
Address1:  
Address2:  
City:  
State:  
Zip:  
Country:  
Phone: 205-529-6732  
Size:  
Industry:  
Interest:  
Reason:

Comments: I know that HealthSouth based out of Birmingham, AL has severe problems in the Accounting Department. In December 2001 HealthSouth moved expenses to capital accounts. The following accounts need to be looked at as of 12-31-2001. 7000, 7200 and 7995.

Web Page: <http://www.ey.com/global/content.nsf/International/Home>



Accounts 7000, 7200, 7995  
HRC  
12/31/2001

7000	Minor Equipment	12/31/2000	12/31/2001	Variance
	Division			
	01	51,222	128,490	
	02	272,445	236,565	
	03	2,054,001	2,433,709	
	04	374,459	418,987	
	05	2,161,850	1,811,829	
	06	365,442	398,837	
	07	23,939	273,140	
	08	145,531	68,383	
	09	-	-	
	10	-	2,801	
	94	21,976	310,520	
	95	952	3,353	
	96	-	-	
		<u>5,471,817</u>	<u>6,086,614</u>	<u>614,797</u>
7200	Repairs + Maintenance			
	01	1,977,841	2,250,945	
	02	2,841,198	3,066,604	
	03	8,364,840	9,632,797	
	04	4,036,967	3,663,753	
	05	13,082,663	13,703,201	
	06	5,701,908	6,775,519	
	07	119,858	250,786	
	08	1,333,764	398,599	
	09	-	-	
	10	-	334	
	94	157,839	174,402	
	95	116,508	91,401	
	96	-	-	
		<u>37,733,386</u>	<u>40,008,341</u>	<u>2,274,955</u>
7995	Public Information			
	01	612,810	3,885,412	
	02	1,066,789	1,199,809	
	03	2,398,231	1,862,027	
	04	2,751,373	2,993,662	
	05	1,191,788	1,277,066	
	06	834,475	937,305	
	07	7,303	11,768	
	08	658,865	122,277	
	09	-	-	
	10	-	1,749	
	94	310,436	732,145	
	95	-	2,071	
	96	-	-	
		<u>9,832,070</u>	<u>13,025,291</u>	<u>3,193,221</u>

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July 13, 2002

To: HealthSouth Corporation 2002 Annual Audit File  
HealthSouth Corporation 2<sup>nd</sup> Quarter Review File

From: J. P. Lamphron

**Results of Review of Allegation of Accounting Irregularities  
at HealthSouth Corporation**

On June 30, 2002, a former employee of HealthSouth Corporation (HRC) sent an e-mail to an Ernst & Young website alleging certain irregularities in accounting at HRC during the year ended December 31, 2001. Specifically, the allegation was as follows: "I know that HealthSouth based out of Birmingham, AL has severe problems in the Accounting Department. In December 2001 HealthSouth moved expenses to capital accounts. The following accounts need to be looked at as of 12-31-01. 7000, 7200 and 7995."

The former HRC employee who had made the allegation had been employed with HRC until recently as an accounting supervisor in their Fixed Asset Department. The account descriptions for the three accounts in questions are as follows: 7000 – Minor Equipment; 7200 – Repairs and Maintenance; and, 7995 – Public Information.

By July 1, 2002, this message was forwarded to me at which time I called Bob Seaman to inform him of the situation and to discuss the necessary follow-up by us. The actions we decided upon were to 1) inform HRC's CFO of the allegation; 2) discuss the situation with either the COO or CEO, or both; 3) to allow the Company a brief period of time to do a preliminary investigation; and, 4) to inform the Chairman of HRC's Audit Committee of the situation. We did not feel there was any need at this time to inform anyone in our legal department.

By July 2, 2002, I had contacted the CFO and discussed the allegations with him. Both the COO and CEO were on vacation and our efforts to arrange a conference call for July 3, 2002 were not successful. Through conversations with the CFO and the COO's secretary, I learned that the COO had been made aware of the allegations. On Monday, July 8, 2002, I had a conference call with HRC's COO, CFO and Controller. We discussed 1) the specifics of the allegation; 2) the person who had made the charges; and, 3) the results of the Company's preliminary investigation into the allegations. As a result of our conference call we decided that E&Y would review the results of HRC's investigation and then follow-up with a call to the Chairman of the Audit Committee. Since the COO indicated during this conference call that the CEO had been briefed on both the charges and the results of HRC's investigation, I did not discuss this situation directly with the CEO.

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HealthSouth Capitalization Policy  
HRC  
12/31/01

HRC policy requires facilities to submit a capital expenditure request (CER) to purchase capital items greater than \$500 (all facilities except O/P) or \$100 (O/P). The CER is reviewed at corporate and when approved, the facility can purchase the item or perform the upgrade that is requested.

The facilities have more latitude on expensing items. Corporate approval is required on items greater than \$5,000 (after the fact) in order to finalize the check processing. Facilities can approve expenditures without pre-approval.

In certain situations, the facility may believe they need an item immediately and cannot wait on the CER process or they may be close to exceeding their capital budget and may choose to circumvent company policy and just expense the item.

On a monthly basis the fixed asset department runs a listing of all transactions affecting expense accounts 7000 (minor equipment), 7200 (repairs and maintenance) and 7001 (minor surgical instruments). This is done to make sure amounts that should be capitalized are not being expensed. Amounts could be expensed either due to coding error by the facility or by the facility attempting to circumvent the system. (NOTE – facilities do not book entries, they fill out the voucher package for AP processing, and on the voucher package the facility indicates the account where the amount should be booked).

The fixed asset department looks at the amounts of the individual expenditures and at the vendor names to determine if it is likely that an amount should be capitalized. They then obtain the AP log – which includes the backup – and review it to determine if the item is a capitalizable cost or an expense. Based on the review, amounts that should be capitalized are identified and a correcting entry is made (most items are reclassified to equipment, leasehold improvements, surgical instruments). In addition, the facility is notified of the change and the reason for the change in an effort to improve the process at the facility level.

Examples of items that facilities may expense that should be capitalized are certain surgical instruments, construction, new carpeting, and smaller dollar items that individually do not meet the policy but do in the aggregate (i.e. 10 - \$400 TV's).

On July 10, 2002, Wayne Dunn-EY senior manager met with Emery Harris-HRC controller and Cathy Edwards-HRC fixed asset manager and reviewed the process. The transaction listings and the correcting entries were reviewed for May 2001 and December 2001. In addition, a sample of invoices was pulled to determine if amounts being capitalized were being appropriately considered. Based on our review, the items sampled were properly considered as capitalizable items and the reclass is appropriate. For the

year ended December 31, 2001 – total amount of reclasses from the accounts were as follows:

7200 - \$1,275,736  
7000 - \$948,093  
7001 - \$1,124,128

In addition we reviewed the reclasses made out of the 7995 Public Information Account. Based on review with the Emery Harris, this account is also reviewed on a monthly basis to make sure items are being accounted for properly. The items that are most common in this area are (1) Items that are expensed which should be set up as a prepaid and then amortized over a period of time, (2) Items which have already been accrued for (outside of AP-in other accruals) for which the item should be offset instead of being expensed, and (3) on a limited basis, there are some items that should be capitalized as PPE. We reviewed the transaction listing for May and December of 2001 and pulled 5 invoices. Based on our review, we noted (1) invoice that was for display racks that was reclassified to PPE, (2) invoice for marketing materials which was reclassified to inventory – these were materials on hand – HRC performs an inventory and adjusts these amounts at that time, (3) invoice for items which had been accrued for in “other payables”, (4) invoice for a 3 month sponsorship – item was set up as a prepaid and amortized over three months, and (5) invoice for a sponsorship that was set up as a deferred expense and later expensed – similar to the item in #4 above. No unusual items were noted, all items reviewed were accounted for properly.

Review of Results of Allegation of Accounting  
Irregularities at HealthSouth Corporation

Page 3  
July 13, 2002

Copy to: C. Miller  
K. Lloyd  
J. Cegala  
B. Seaman



K	Jnl ID	B.U.	Facility	Journal Description	Date	Acct	Dpt	Satellite	Custom	Trans Amt
L	12AMREP01	03	030060	CAP INTERNET COSTS	12/31/2001	7200	819			-3,519.32
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-3,500.00
L	12AMREP01	03	030048	CAP INTERNET COSTS	12/31/2001	7200	850			-3,498.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	815			-3,482.17
L	12AMREP01	03	030074	CAP INTERNET COSTS	12/31/2001	7200	850			-3,445.89
L	12AMREP01	03	030037	CAP INTERNET COSTS	12/31/2001	7200	229			-3,437.67
L	12AMREP01	03	030077	CAP INTERNET COSTS	12/31/2001	7200	999			-3,416.00
L	12AMREP01	03	030100	CAP INTERNET COSTS	12/31/2001	7200	850			-3,403.07
L	12AMREP01	03	030097	CAP INTERNET COSTS	12/31/2001	7200	850			-3,400.00
L	12AMREP01	03	030059	CAP INTERNET COSTS	12/31/2001	7200	905			-3,397.72
L	12AMREP01	03	030140	CAP INTERNET COSTS	12/31/2001	7200	850			-3,383.11
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	905			-3,380.85
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	905			-3,380.85
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	229			-3,380.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-3,354.54
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-3,354.54
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	850			-3,335.00
L	12AMREP01	03	030130	CAP INTERNET COSTS	12/31/2001	7200	310			-3,335.00
L	12AMREP01	03	030130	CAP INTERNET COSTS	12/31/2001	7200	310			-3,335.00
L	12AMREP01	03	030130	CAP INTERNET COSTS	12/31/2001	7200	310			-3,304.63
L	12AMREP01	03	030130	CAP INTERNET COSTS	12/31/2001	7200	310			-3,304.63
L	12AMREP01	03	030031	CAP INTERNET COSTS	12/31/2001	7200	103			-3,286.38
L	12AMREP01	03	030122	CAP INTERNET COSTS	12/31/2001	7200	850			-3,286.34
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850			-3,235.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850			-3,235.00
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	850			-3,234.47
L	12AMREP01	03	030047	CAP INTERNET COSTS	12/31/2001	7200	850			-3,200.00
L	12AMREP01	03	030040	CAP INTERNET COSTS	12/31/2001	7200	201			-3,200.00
L	12AMREP01	03	030057	CAP INTERNET COSTS	12/31/2001	7200	790			-3,196.00
L	12AMREP01	03	030050	CAP INTERNET COSTS	12/31/2001	7200	905			-3,156.60
L	12AMREP01	03	030077	CAP INTERNET COSTS	12/31/2001	7200	999			-3,164.08
L	12AMREP01	03	030129	CAP INTERNET COSTS	12/31/2001	7200	850	03012901		-3,146.80
L	12AMREP01	03	030063	CAP INTERNET COSTS	12/31/2001	7200	850			-3,100.00
L	12AMREP01	03	030002	CAP INTERNET COSTS	12/31/2001	7200	850			-3,084.23
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-3,082.86
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-3,082.86
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	201			-3,056.06
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850			-3,052.00
L	12AMREP01	03	030002	CAP INTERNET COSTS	12/31/2001	7200	850			-3,050.00
L	12AMREP01	03	030056	CAP INTERNET COSTS	12/31/2001	7200	905			-3,030.00
L	12AMREP01	03	030060	CAP INTERNET COSTS	12/31/2001	7200	850			-3,018.79
L	12AMREP01	03	030060	CAP INTERNET COSTS	12/31/2001	7200	961			-3,000.00
L	12AMREP01	03	030066	CAP INTERNET COSTS	12/31/2001	7200	901			-3,000.00
L	12AMREP01	03	030076	CAP INTERNET COSTS	12/31/2001	7200	999			-3,000.00
L	12AMREP01	03	030083	CAP INTERNET COSTS	12/31/2001	7200	850			-3,000.00
L	12AMREP01	03	030083	CAP INTERNET COSTS	12/31/2001	7200	850			-3,000.00
L	12AMREP01	03	030157	CAP INTERNET COSTS	12/31/2001	7200	850			-3,000.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850			-2,965.88
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850			-2,965.88
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-2,950.00
L	12AMREP01	03	030083	CAP INTERNET COSTS	12/31/2001	7200	850			-2,950.00
L	12AMREP01	03	030053	CAP INTERNET COSTS	12/31/2001	7200	850			-2,928.57
L	12AMREP01	03	030002	CAP INTERNET COSTS	12/31/2001	7200	850			-2,928.00
L	12AMREP01	03	030039	CAP INTERNET COSTS	12/31/2001	7200	905			-2,916.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-2,915.76
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-2,915.76
L	12AMREP01	03	030119	CAP INTERNET COSTS	12/31/2001	7200	850			-2,907.00
L	12AMREP01	03	030133	CAP INTERNET COSTS	12/31/2001	7200	850			-2,905.00
L	12AMREP01	03	030129	CAP INTERNET COSTS	12/31/2001	7200	850			-2,899.20
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	230			-2,872.83
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850			-2,867.76
L	12AMREP01	03	030014	CAP INTERNET COSTS	12/31/2001	7200	850			-2,856.81
L	12AMREP01	03	030140	CAP INTERNET COSTS	12/31/2001	7200	850			-2,852.39
L	12AMREP01	03	030140	CAP INTERNET COSTS	12/31/2001	7200	850			-2,852.39
L	12AMREP01	03	030063	CAP INTERNET COSTS	12/31/2001	7200	835			-2,844.26
L	12AMREP01	03	030122	CAP INTERNET COSTS	12/31/2001	7200	850			-2,838.00
L	12AMREP01	03	030122	CAP INTERNET COSTS	12/31/2001	7200	850			-2,838.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	102			-2,836.50
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	101			-2,836.50
L	12AMREP01	03	030102	CAP INTERNET COSTS	12/31/2001	7200	850			-2,820.43
L	12AMREP01	03	030056	CAP INTERNET COSTS	12/31/2001	7200	905			-2,820.11
L	12AMREP01	03	030077	CAP INTERNET COSTS	12/31/2001	7200	999			-2,806.00
L	12AMREP01	03	030014	CAP INTERNET COSTS	12/31/2001	7200	850			-2,783.50

X	Facility ID	B.D.	Facility	Journal Description	Date	Acct	Dpt	Satellite	Custom	Trans	Amt
L	12AMREP01	03	030014	CAP INTERNET COSTS	12/31/2001	7200	850				-2,793.50
L	12AMREP01	03	030014	CAP INTERNET COSTS	12/31/2001	7200	850				-2,793.50
L	12AMREP01	03	030014	CAP INTERNET COSTS	12/31/2001	7200	850				-2,793.50
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,775.08
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,775.08
L	12AMREP01	03	030048	CAP INTERNET COSTS	12/31/2001	7200	850				-2,771.63
L	12AMREP01	03	030129	CAP INTERNET COSTS	12/31/2001	7200	850				-2,745.60
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,740.00
L	12AMREP01	03	030097	CAP INTERNET COSTS	12/31/2001	7200	819				-2,737.87
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,720.00
L	12AMREP01	03	030077	CAP INTERNET COSTS	12/31/2001	7200	999				-2,718.58
L	12AMREP01	03	030129	CAP INTERNET COSTS	12/31/2001	7200	850				-2,712.50
L	12AMREP01	03	030093	CAP INTERNET COSTS	12/31/2001	7200	850				-2,708.65
L	12AMREP01	03	030053	CAP INTERNET COSTS	12/31/2001	7200	743				-2,703.00
L	12AMREP01	03	030053	CAP INTERNET COSTS	12/31/2001	7200	215				-2,703.00
L	12AMREP01	03	030104	CAP INTERNET COSTS	12/31/2001	7200	850				-2,701.74
L	12AMREP01	03	030104	CAP INTERNET COSTS	12/31/2001	7200	850				-2,701.74
L	12AMREP01	03	030102	CAP INTERNET COSTS	12/31/2001	7200	850				-2,695.68
L	12AMREP01	03	030014	CAP INTERNET COSTS	12/31/2001	7200	819				-2,694.06
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,686.65
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	850				-2,684.20
L	12AMREP01	03	030048	CAP INTERNET COSTS	12/31/2001	7200	905				-2,648.00
L	12AMREP01	03	030100	CAP INTERNET COSTS	12/31/2001	7200	819				-2,638.40
L	12AMREP01	03	030140	CAP INTERNET COSTS	12/31/2001	7200	850				-2,635.00
L	12AMREP01	03	030122	CAP INTERNET COSTS	12/31/2001	7200	850				-2,631.08
L	12AMREP01	03	030048	CAP INTERNET COSTS	12/31/2001	7200	850				-2,628.80
L	12AMREP01	03	030039	CAP INTERNET COSTS	12/31/2001	7200	850				-2,618.00
L	12AMREP01	03	030039	CAP INTERNET COSTS	12/31/2001	7200	850				-2,618.00
L	12AMREP01	03	030039	CAP INTERNET COSTS	12/31/2001	7200	850				-2,618.00
L	12AMREP01	03	030047	CAP INTERNET COSTS	12/31/2001	7200	850				-2,614.32
L	12AMREP01	03	030047	CAP INTERNET COSTS	12/31/2001	7200	850				-2,614.32
L	12AMREP01	03	030047	CAP INTERNET COSTS	12/31/2001	7200	850				-2,614.32
L	12AMREP01	03	030046	CAP INTERNET COSTS	12/31/2001	7200	815				-2,580.94
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,556.00
L	12AMREP01	03	030119	CAP INTERNET COSTS	12/31/2001	7200	999				-2,554.62
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,530.00
L	12AMREP01	03	030037	CAP INTERNET COSTS	12/31/2001	7200	229				-2,528.45
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	850				-2,525.78
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	850				-2,525.78
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	850				-2,520.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,520.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,520.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,520.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,520.00
L	12AMREP01	03	030157	CAP INTERNET COSTS	12/31/2001	7200	850				-2,518.41
L	12AMREP01	03	030031	CAP INTERNET COSTS	12/31/2001	7200	201	03003105			-2,500.00
L	12AMREP01	03	030031	CAP INTERNET COSTS	12/31/2001	7200	201	03003105			-2,500.00
L	12AMREP01	03	030046	CAP INTERNET COSTS	12/31/2001	7200	905				-2,500.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,500.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,500.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,500.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,500.00
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,500.00
L	12AMREP01	03	030050	CAP INTERNET COSTS	12/31/2001	7200	819				-2,498.30
L	12AMREP01	03	030134	CAP INTERNET COSTS	12/31/2001	7200	850				-2,472.00
L	12AMREP01	03	030016	CAP INTERNET COSTS	12/31/2001	7200	819				-2,468.25
L	12AMREP01	03	030130	CAP INTERNET COSTS	12/31/2001	7200	201				-2,452.50
L	12AMREP01	03	030130	CAP INTERNET COSTS	12/31/2001	7200	201				-2,452.50
L	12AMREP01	03	030122	CAP INTERNET COSTS	12/31/2001	7200	850				-2,442.31
L	12AMREP01	03	030160	CAP INTERNET COSTS	12/31/2001	7200	850				-2,430.50
L	12AMREP01	03	030057	CAP INTERNET COSTS	12/31/2001	7200	850				-2,428.81
L	12AMREP01	03	030017	CAP INTERNET COSTS	12/31/2001	7200	850				-2,428.44
L	12AMREP01	03	030017	CAP INTERNET COSTS	12/31/2001	7200	850				-2,428.44
L	12AMREP01	03	030017	CAP INTERNET COSTS	12/31/2001	7200	850				-2,428.44
L	12AMREP01	03	030053	CAP INTERNET COSTS	12/31/2001	7200	850				-2,427.51
L	12AMREP01	03	030043	CAP INTERNET COSTS	12/31/2001	7200	201				-2,427.04
L	12AMREP01	03	030076	CAP INTERNET COSTS	12/31/2001	7200	850				-2,427.00
L	12AMREP01	03	030129	CAP INTERNET COSTS	12/31/2001	7200	850				-2,416.33
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,415.00
L	12AMREP01	03	030033	CAP INTERNET COSTS	12/31/2001	7200	850				-2,415.00
L	12AMREP01	03	030017	CAP INTERNET COSTS	12/31/2001	7200	850				-2,402.97
L	12AMREP01	03	030049	CAP INTERNET COSTS	12/31/2001	7200	850				-2,400.00
L	12AMREP01	03	030050	CAP INTERNET COSTS	12/31/2001	7200	850				-2,392.86

Facility	Profile Id	Description	Date	Vendor	Invoice Number	Amount	Medicare Code
0300200	SOFTWARECAP	INTERNET	03/21/2001	FLORENCE CARPET & TILE, INC.	160814	541.73	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	B&B MARINE AND INDUSTRIAL BOILERS	16246	1,920.10	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	DE LAGE LANDEN FINANCIAL SERVICES INC	0111989030	2,289.63	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	DE LAGE LANDEN FINANCIAL SERVICES INC	0109726795	2,289.63	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	DE LAGE LANDEN FINANCIAL SERVICES INC	01120011618	2,289.63	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	AVAYA, INC.	0100694470	2,316.37	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	HOLLEY DEPOT TECHNICAL SERVICES, INC.	225983	2,925.00	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	C.B. COLLINS ELECTRIC CO., INC.	2054	3,050.00	AG
0300200	SOFTWARECAP	INTERNET	03/21/2001	CAROLINA AIR FILTERS	2002-01-10	3,086.22	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	VWV GRAINGER, INC.	931-879310-7	536.88	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	PREMIER, INC	N100312636	574.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	PREMIER, INC	N100310028	574.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	WALKER-WHITE	020773	593.20	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	PREMIER, INC	4R00301919	623.93	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	PREMIER, INC	4100300623	639.20	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	PREMIER, INC	4100300753	796.32	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	MASCO AUTOMOTIVE SYSTEMS	S-7483	819.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	CLELAND MECHANICAL	4219	896.38	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	MASCO AUTOMOTIVE SYSTEMS	S-7244	962.73	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	TELEHEALTH SERVICES	192667	1,240.40	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	BESAM AUTOMATED ENTRANCE SYSTEMS, INC	SEI00131711	1,500.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	CHEERS UPHOLSTERY	182509	2,100.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	CLELAND MECHANICAL	4250	597.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	MECHANICAL ENGINEERING CONSULTING ASSOCIATES	0201320	597.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	CLELAND MECHANICAL	4269	597.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	PAMECO CORPORATION	13826553	539.54	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	R&M - FILTER TECH	2001-11-06	574.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	R&M - CURBELL	2001-11-06	619.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	CURBELL INC	190280	619.72	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	FILTER TECHNOLOGY CO INC	20829	622.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	SOUTHERN LOCK	2001-11-12	657.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	DOOBIE DOO GREASE EXHAUST SYSTEM	130313	687.39	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	SPLIT SW DATACOM 800 AND 802	2001-12-12	754.01	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	REPAIRS/MANT IC JANITORIAL	2001-11-06	816.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	SOUTHWEST DATACOM SYSTEMS	53792	1,508.02	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	SOUTHWEST DATACOM	2001-11-12	1,520.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	RECL B&B TO R&M FRM CONTRACT S	2002-01-04	1,558.80	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	B&B WALLCOVERING	2001-12-12	1,559.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	B&B WALLCOVERING	2001-11-12	1,905.00	AG
0300100	SOFTWARECAP	INTERNET	03/21/2001	B & B WALLCOVERING	4120	1,905.20	AG
03001400	SOFTWARECAP	INTERNET	03/21/2001	HOBBART CORPORATION	18736829	646.23	AG

03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	ACCURALS	2001-11-05	680.00	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MED-DISPENSE, LLC	001510	680.00	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HOBART CORPORATION	18643653	812.39	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	DOWNTOWN GOODYEAR	6058	903.10	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	CONNECTIONS 21	31631	980.50	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	ACCURALS	2001-12-06	1,645.73	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	ACCURALS	2001-11-05	1,773.74	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	DOWNTOWN GOODYEAR	3108	1,790.99	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	ACCURALS	2001-12-06	2,694.09	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AWAITING CER APPROVAL - FIXED	2001-11-23	2,793.50	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	FIXED ASSET ADJ	2001-12-21	2,793.50	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	CONNECTIONS 21 INVOICE	2001-10-22	2,793.50	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	CONNECTIONS 21	31556	2,858.61	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	THE TRANE COMPANY	129334	508.79	AG
03001400	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HANCOCK'S MEDICAL ELECTRONIC SVC	8641	522.31	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -SIMPLEX	2001-12-04	522.31	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	SIMPLEX TIME RECORDER COMPANY, INC	12103121	530.43	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HEALTHCARE BIOMEDICAL SERVICES INC	7185	538.77	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	RALPH WRIGHT COMMERCIAL REFRIGERATION/2054		538.77	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	RALPH WRIGHT COMMERCIAL REFRIGERATION/2054		538.77	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	DOUBLE EAGLE	8613	553.88	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MASIF'S TEXACO	09302001	622.02	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	DECEMBER PREPAIDS	2002-01-01	631.45	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	OCTOBER PREPAIDS	2001-11-02	631.46	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	NOVEMBER PREPAIDS	2001-12-01	631.46	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -CHEMSEARCH	2001-12-04	689.60	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	CHEMSEARCH DIVISION (NCH CORPORATION)	682897	689.60	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -RALPH WRIGHT	2001-12-04	712.56	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -STOVE PARTS	2002-01-10	972.78	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	DOUBLE EAGLE	8523	1,154.87	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MASIF'S TEXACO	10312001	1,351.55	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	DOUBLE EAGLE	8223	1,479.67	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HEALTHCARE BIOMED	2001-10-22	1,530.69	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -MASIF	2002-01-03	1,671.46	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -HEALTHCARE BIO	2002-01-10	1,811.69	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	AP ACCRUAL -HAROLD JAMES	2001-12-04	1,933.43	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HAROLD JAMES, INC.	014370	1,933.43	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MASIF'S TEXACO	11302001	2,469.25	AG
03001600	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HAROLD JAMES, INC.	014371	3,951.13	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL	2002-01-10	513.50	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	TRI-CITIES BATTERY	231868	553.19	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL	2002-01-10	611.68	AG

03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	BRISTOL SUPPLY AND EQUIPMENT CO	102007	679.10	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	FAIRWAY FORD	F0CS93268	802.50	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL CORP	SD286018	843.68	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL	2002-01-10	867.75	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	THOUN ENTERPRISES, INC	140536	875.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	BRISTOL SUPPLY	2001-12-05	884.74	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	KINGSPOET CABINETRY & FLOORING	861	910.69	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL CORP	SD286015	1,146.34	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL CORP	SD286009	1,533.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	PREPAID EXPENSE -BOEHM LANDSCA	2001-11-01	2,375.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	PREPAID EXPENSE -BOEHM LANDSCA	2001-12-03	2,375.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	PREPAID EXPENSE -BOEHM LANDSCA	2002-01-01	2,375.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	RECLASS TO CORRECT DEPT	2001-11-13	2,375.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	RECLASS REPAIRS & MAINT	2001-12-12	2,375.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	RECLASS TO CORRECT DEPT	2002-01-10	2,375.00	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	KINGSPOET CABINETRY & FLOORING	860	2,402.59	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	YORK INTERNATIONAL CORP	SD286011	2,402.87	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	PREPAID EXPENSE - YORK INTERNA	2001-11-01	2,426.44	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	PREPAID EXPENSE - YORK INTERNA	2001-12-03	2,426.44	AG
03001700	SOFTWARECAP	INTERNET	COSTS/2/31/2001	PREPAID EXPENSE - YORK INTERNA	2002-01-01	2,426.45	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MOODY SPRINKLER CO, INC.	11341	4,410.22	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MARTEL'S SELF-CARE PRODUCTS, INC.	18329	509.10	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	SOUTHWORTH MILTON POWER SYSTEMS RENTSERV0323260	18542789	638.43	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HOBART CORPORATION	2002-01-08	722.48	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	FORD MOTOR CREDIT	2002-01-09	791.94	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	FORD MOTOR CREDIT	JHN132E32W	791.94	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	FORD MOTOR CREDIT	JHN132E32W	791.94	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	FORD MOTOR CREDIT	JHN132E32W	791.94	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	BIODEX MEDICAL SYSTEMS, INC.	130745	1,280.50	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	NORTHEAST DOOR CORPORATION	01-11-547	1,372.50	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	EMCOR SERVICE	435024	1,496.73	AG
03001900	SOFTWARECAP	INTERNET	COSTS/2/31/2001	HAMPSHIRE FIRE PROTECTION CO., INC.	21691	1,625.00	AG
03002100	SOFTWARECAP	INTERNET	COSTS/2/31/2001	CHATTANOOGA	161712	674.50	AG
03002100	SOFTWARECAP	INTERNET	COSTS/2/31/2001	ACE GLASS SERVICE	2002-01-04	790.17	AG
03002100	SOFTWARECAP	INTERNET	COSTS/2/31/2001	MANNINGTON CARPETS, INC	286555	1,346.25	AG
03002100	SOFTWARECAP	INTERNET	COSTS/2/31/2001	NEON SOUTH	2002-01-04	2,000.00	AG
03002100	SOFTWARECAP	INTERNET	COSTS/2/31/2001	INVENSYS BLDG. SYS.	2002-01-04	2,283.00	AG
03002100	SOFTWARECAP	INTERNET	COSTS/2/31/2001	INVENSYS BUILDING SYSTEMS INC	2002-01-08	2,283.00	AG
03002200	SOFTWARECAP	INTERNET	COSTS/2/31/2001	INVENSYS BUILDING SYSTEMS INC	2002-01-09	2,283.00	AG
03002200	SOFTWARECAP	INTERNET	COSTS/2/31/2001	GORRIE REGAN & ASSOCIATES, INC.	50413	955.00	AG

Meeting with HRC Management  
September 3, 2002

Tab 80

On September 3, 2002, Jim Lamphron-Partner, Wayne Dunn-Senior Manager and Mike Mills-Manager, met with Weston Smith-CFO and Emery Harris-Controller to discuss the recent news that HRC had released regarding reduced reimbursement on physical therapy and the repercussions in the markets as a result - HRC stock is down significantly and there are several shareholder suits being filed.

Mr. Smith provided the following information. On May 17, 2002 a transmittal letter went out to Part B carriers only (see attached) - HRC did not receive the letter directly. After the letter came out, an attorney working with HRC had seen a copy of the transmittal letter and asked HRC if they had seen it. HRC had not and asked the attorney to send them a copy. HRC (Susan Smith) then followed up with Blue Cross, their Medicare Fiscal Intermediary, to see if the transmittal letter applied to them. Blue Cross said the letter did not apply to HRC. HRC asked for something in writing from Blue Cross and then Blue Cross decided they needed to review the issue further. HRC set up a meeting with the Center for Medicare and Medicaid Services (CMS) to discuss the issue's applicability to HRC. CMS was not sure if it applied either and wanted to study it further. HRC took a conservative approach and treated the transmittal letter as if it did apply until more clear guidance was given. On August 15, 2002, HRC and CMS had a follow up meeting. At that meeting, Tom Grissom (the author of the transmittal letter) was present and CMS said that the guidance did apply to HRC. HRC then did an internal analysis on the impact to the Company. They looked at the impact related to Medicare and contracts that pay on Medicare fee screen rates and looked at the impact it would have on the non-Medicare business. Estimated impact of \$175 million, is 1/2 Medicare, 1/2 non-Medicare. On August 20, the Company released a statement discussing the change in the guidance and the estimated economic impact.

5 days  
annually

HRC is looking to increase hiring where it is possible, but some facilities have space constraints and additional hiring is not a viable solution. HRC is pursuing all avenues to minimize the impact of this guidance. All billings from July 1 forward were corrected to be in compliance with the guidance.

Mr. Smith also had a discussion with Tom Scully, director of CMS. Mr. Scully stated that he would be looking further into the impact of this guidance.

On the afternoon of September 3, 2002, Wayne Dunn and Mike Mills also met with Bill Horton, corporate counsel, to discuss the same issue. He confirmed the timeline above and is providing a detailed timeline of events (see attached). He said the suits are standard shareholder suits that occur when there is a large drop in the stock price. The Company is in process of identifying and assigning counsel. He also stated these cases tend to take a lot of time, and he believes HRC has a strong defense. We inquired regarding the lack of 10Q disclosure surrounding this event and Mr. Horton stated that there was no definitive information until August 15, 2002 and therefore at the time of filing the 10Q, the Company could not disclose what they did not know.

(August 14, 2002)

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FOIA CONFIDENTIAL  
TREATMENT REQUESTED  
BY ERNST&YOUNG LLP

(VOS-0-0618-0  
DATE 4/9/03  
DIFF EXHIBIT NO. 31

J. H. L. B. 2  
J. H. L. B. 2  
A2-4  
A2

**Medicare  
Carriers Manual  
Part 3 - Claims Process**

Department of Health &  
Human Services (DHHS)  
Centers for Medicare &  
Medicaid Services (CMS)

Transmittal 1753

Date: MAY 17, 2002

**CHANGE REQUEST 2126**

<u>HEADER SECTION NUMBERS</u>	<u>PAGES TO INSERT</u>	<u>PAGES TO DELETE</u>
Table of Contents - Chapter XV	15-1 - 15-2 (2 pp.)	15-1 - 15-2 (2 pp.)
15002 - 15006 (Cont.)	15-3 - 15-4.1 (3 pp.)	15-3 - 15-4.1 (3 pp.)
15200 - 15501 (Cont.)	15-71 - 15-74.1 (5 pp.)	15-71 - 15-74.1 (5 pp.)

**NEW/REVISED MATERIAL—EFFECTIVE DATE: July 1, 2002  
IMPLEMENTATION DATE: May 17, 2002**

Section 15002, Physicians' Services Paid Under Fee Schedule, is revised to clarify the payment policy for bad debts.

Section 15302, Group Therapy Services (Code 97150), is added to clarify payment policy for group therapy services.

**CLARIFICATION/MANUALIZATION—EFFECTIVE DATE: Not Applicable  
IMPLEMENTATION DATE: Not Applicable**

Section 15304, Therapy Students, manualizes PM AB-01-56, "Questions and Answers Regarding Payment for the Services of Therapy Students Under Part B of Medicare."

**DISCLAIMER: The revision date and transmittal number only apply to the redlined material. All other material was previously published in the manual and is only being reprinted.**

These instructions should be implemented within your current operating budget.

CMS-Pub. 14-3

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Tab 81

Title GAAP CHECKLIST

Client HRC

Subsidiary or Division \_\_\_\_\_

Audit Date 12/31/02

INDEX

AI

\_\_\_\_\_ of \_\_\_\_\_

Title Divider

Folder Number

File Number



EYO2 000002  
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Open Items for Discussion with Bill Owens  
February 18, 2003

General

- ✓ 1) Elimination entry related to surgery centers that should not be consolidated
- ✓ 2) There are some inpatient facilities that are 50% or less owned – should any of these be deconsolidated? Based on my review of the Portland I/P facility, it should be deconsolidated
- ✓ 3) Non-standard journal entries – what processes are in place to monitor these? What are these entries? We need approval to get all journal entries for the year electronically so we can review all entries. Suggestion – Make notation within JE's that identifies non-standard entries, and get detailed financial statement close checklists put together to monitor these entries.
- ✓ 4) Derivatives identifier checklist needed from Richard Davis
- ✓ 5) Message Board comments – any awareness of any inappropriate capitalization of expenses? *- mainly can't happen - systems in place - cost/unit assumed ok*
- 6) Identification of exposure (liability) related to employment agreement with Scrusby, Tanner and Beam (left message with Horton to get Beam and Tanner agreements). Are there any other employees that have retirement benefits? *indicators assumed*
- ✓ 7) We need copies of all Board minutes for the year (Talking to Horton) *↓*
- ✓ 8) Awaiting legal letter responses *minutes*
- ✓ 9) General audit procedure of testing officer expenses in process – Scrusby, Owens, Taylor, Foster, Hale *it's →*
- ✓ 10) What are the plans for the Orlando trip? *- Contact Bill* *could stand out*

Cash

- 11) Interim procedures complete -- TO DO -- review year end reconciliations *from → + are early - by mid-day - for Board Meeting Fri Morning*

Accounts Receivable

- ✓ 12) A/R Reconciliations - complete
- ✓ 13) Testing of agings – in process – Ginny assisting with financial class testing
- ✓ 14) Memo on testing of Pristine Auditors – Frey get with Mills and Jason Spector

Allowances

- ✓ 15) All client assistance outstanding – Bad Debt Grid – support for allowance balances – agings by division - allowance as a percent of A/R is down from 3<sup>rd</sup> Q

Retros

- 16) In process – see open item list – concerns – Doctors, Larkin and Med Center PY retros, San Diego Appeal, LIP calculation

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**Internal Control and Fraud Considerations**

Tab 82

Client HEALTHSOUTH Corporation  
 Subsidiary or Division \_\_\_\_\_  
 Audit Date 12/31/02

Completed or Updated by	Date	Reviewed and Approved by	Date
See AWS		See AWS	

**General**

This questionnaire assists us in gaining an understanding of and assessing internal control at the entity level and in assessing the risk of fraud. This questionnaire provides us with only a portion of the understanding about an entity's internal control that we are required to obtain to plan the audit (e.g., make our preliminary combined inherent and control risk assessments) and to determine the nature, timing, and extent of our audit procedures. We also are required to obtain information about internal control at the individual application/process level.

This questionnaire has been designed to be completed/updated electronically or manually. To complete/update the questionnaire electronically, click in the appropriate box to the right of the risk factor. Clicking in the box will enter an "X," clicking again will remove the "X."



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We complete this questionnaire for each of the five components of internal control (i.e., the control environment, the client's risk assessment process, information and communication, control activities, and monitoring) for the entity as a whole. In addition, for multilocation engagements, we complete the applicable sections of the questionnaire and make our assessments for those locations (e.g., subsidiaries, divisions) at which we perform full-scope procedures. For example, at a large subsidiary where we perform full-scope procedures, we would prepare/update the questionnaire as it relates to that subsidiary. However, certain sections (e.g., "Board of Directors and/or Audit Committee Participation in governance and oversight") may not be applicable and need not be completed. The partner in charge of the audit determines whether some or all of the questionnaire should be completed at locations where we do not perform full-scope procedures. In making this determination, the partner in charge of the audit considers such factors as the materiality of the location; the nature and extent of our procedures at the location; the nature and extent of the location's operations and the similarity of its operations, systems, and procedures to those at other locations; the degree of operating autonomy granted the location; whether the internal auditors have completed (and we have reviewed) a similar questionnaire for the location; our understanding of the business and financial statement risks associated with the location; the client's expectations; and concerns about internal control or fraud resulting from our prior experiences.

The questionnaire should be completed/updated by those on the engagement team with sufficient experience and knowledge of the client to know, with a high degree of confidence, whether the risk factors in the questionnaire are present and whether additional risk factors should be considered. Further, those same individuals ordinarily are involved in making our assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud.

Because the process of completing/updating the questionnaire frequently will require input from more than one team member, the process ordinarily can be accomplished in a more effective and efficient manner when the engagement team (including the partner) discusses, early in the engagement, which individual(s) will be responsible for completing/updating which sections of the questionnaire. For example, the partner or senior manager (who ordinarily have interaction with the board of directors and/or the audit committee) normally are the only members of the engagement team with sufficient knowledge to respond to the items in the section entitled "Board of Directors and/or Audit Committee Participation in governance and oversight," while the manager and senior (when they have worked on the engagement before) ordinarily will have sufficient knowledge of the client and its business to complete/update most of the remainder of the questionnaire, with input as necessary from others on the engagement team.

The first time the questionnaire is completed (whether for a first-year or recurring audit) the executive in charge of the audit reviews and approves it. In subsequent years, at least a manager reviews and approves the questionnaire.

Each year a copy of the "Summary and Conclusions" page(s) of this questionnaire is attached to the Audit Strategies Memorandum.

We also review and update this questionnaire during our annual client continuance process whenever we assess our risk relating to the client as "other than low" on Form U574, "Evaluation of Audit Clients—Risk Assessment." In such situations, we attach a copy of the updated questionnaire to Form U575, "Audit Client Continuance Form."

#### **Risk Factors**

This questionnaire contains lists of risk factors that are relevant to internal control at the entity level and/or the risk of fraud. However, the lists are not necessarily all inclusive. Based on our understanding of the client and its business and industry, we may identify other risk factors that should be considered and documented in the questionnaire.

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The relative importance of the risk factors varies among engagements from critical to insignificant. Some of the factors will be present in clients where the specific conditions do not present a weakness in internal control at the entity level or present a risk of fraud, while in other situations, they may. Accordingly, we exercise considerable professional judgment when considering the risk factors individually and in combination. When considering the presence of risk factors, we consider whether there are other factors or specific controls that mitigate or exacerbate the risk factors we have identified.

While a "yes" response to a risk factor does not necessarily mean that internal control at the entity level is ineffective or there is a risk of fraud, a "yes" response (particularly when there are multiple "yes" responses) to a risk factor should heighten our awareness, and we give it (them) due consideration.

In instances where a risk factor is not applicable, mark the "No" column for the risk factor and discuss why that particular risk factor is not applicable in space provided below the risk factors. In addition, risk factors known to the engagement team but not included in this questionnaire should be added to the applicable sections.

#### **Considerations for Smaller Entities**

Our evaluation of the risk factors in this questionnaire should consider the unique circumstances, as well as the size and complexity, of smaller entities. For example, an entrepreneurial client may not have a written code of conduct or formally documented corporate policies and procedures. In these instances, we pay particular attention to the "tone" set by management in its own actions, as well as its efforts to communicate to employees the company's policies and values and the importance of integrity and ethical behavior. Similarly, an entrepreneurial client may not have an independent or outside member on its board of directors. If so, we consider the degree of diligence exhibited by management and the board of directors in executing their corporate governance responsibilities. These conditions may not negatively affect our assessment of control risk or of the risk of fraud. We recognize that entrepreneurial entities, by nature, will have varying degrees of internal control. As a result, judgment is involved in determining the effects of internal control at the entity level on our audit approach.

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**Control Environment**

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. We obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitudes, awareness, and actions concerning the control environment, considering both the substance of controls and their collective effects.

The control environment consists of the following factors:

- Integrity, ethical values, and behavior of key executives.
- Management's control consciousness and operating style.
- Management's commitment to competence. Board of directors and/or audit committee participation in governance and oversight.
- Organizational structure and assignment of authority and responsibility.
- Human resource policies and practices.

When gaining an understanding of the control environment, we consider each of these factors and their interrelationships. In particular, we recognize that significant deficiencies in any one of the factors may undermine the effectiveness of the others.

***Integrity and Ethical Values, and the Behavior of Key Executives***

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of key processes. Integrity and ethical behavior are the product of the client's ethical and behavioral standards, how they are communicated, and how they are monitored and enforced in its business activities. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of the entity's values and behavioral standards to personnel through policy statements and codes of conduct, and by the examples set by the executives.

*Are the following risk factors present?*

	<u>Yes</u>	<u>No</u>
• Lack of policies regarding the client's values and behavioral standards and lack of codes of conduct.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Ineffective means of communicating and supporting the client's values or ethics.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not attempt to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not lead by example.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not take appropriate action in response to departures from approved policies and procedures or the code of conduct.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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Indicate other risk factors considered:

**Management's Control Consciousness and Operating Style**

Management's control consciousness and operating style have a pervasive effect on internal control.

<i>Are the following risk factors present?</i>	Yes	No
• Management is dominated by one or a few individuals without effective oversight by the board of directors or audit committee.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management lacks a proven track record in this or other businesses.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management's excessive interest in maintaining or increasing the client's stock price or earnings trend.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Management's failure to give appropriate attention to internal control, including the effects of information systems processing.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management's failure to correct known reportable conditions on a timely basis.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management sets unduly aggressive financial targets and expectations for operating personnel.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• A significant portion of management's compensation is derived from bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results or financial position.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management is aggressive in selecting accounting principles and determining estimates.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management commits to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management does not consult us on significant matters relating to internal control and accounting issues or there are frequent disputes regarding them (or for initial engagements, there were disputes with the predecessor auditors).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management displays a cavalier attitude toward, and inadequate monitoring of, significant business risks.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

- Management displays significant disregard for regulatory authorities.
- There is a history of securities law violations or claims against the client or its management alleging fraud or violations of securities laws.
- Management displays significant disregard for the audit.
- Management is domineering in dealing with us.
- Management attempts to reduce the scope of the audit (directly, for example, by limiting access to people or information, or indirectly, for example, by unreasonable fee or time constraints) or imposes unreasonable deadlines.
- Management attempts to limit our ability to communicate effectively with the board of directors or the audit committee.

Indicate other risk factors considered:

**Management's Commitment to Competence**

Management's commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge. Among the many factors that should be considered by management are the nature and degree of judgment to be applied to a specific job and the extent of supervision that will be provided.

- | <i>Are the following risk factors present?</i>  | Yes                      | No                                  |
|---|--------------------------|-------------------------------------|
| • The accounting, finance, and IT personnel do not have the competence and training needed to deal with the nature and complexity of the entity's business.                                     | <input type="checkbox"/> | <input checked="" type="checkbox"/> |
| • Lack of commitment by management to provide sufficient accounting and financial personnel to keep pace with the growth and/or complexity of the business and the demands of the stakeholders. | <input type="checkbox"/> | <input checked="" type="checkbox"/> |

Indicate other risk factors considered:

See risks associated with the internal audit function.

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**Board of Directors and/or Audit Committee Participation in Governance and Oversight**

The client's control consciousness is influenced significantly by the board of directors and/or audit committee. The board of directors, through its own activities and supported by an audit committee or an equivalent function, is responsible for overseeing the client's accounting and financial reporting policies and procedures.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Board of directors does not have a charter or objectives for the audit committee.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate communications among the board, audit committee, and external and internal auditors.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Audit committee members are not appropriately experienced or qualified.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors or audit committee is not sufficiently independent of management.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate number of meetings or the matters discussed are not appropriate.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors and audit committee do not adequately scrutinize activities—difficult questions are not raised and pursued with management.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors and/or audit committee are not adequately involved in the financial reporting process.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Board of directors and/or audit committee do not give adequate consideration to monitoring business risks affecting the organization and management's risk assessment processes.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High turnover of board members.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

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**Organizational Structure and Assignment of Authority and Responsibility**

The client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The client should have an organizational structure that is suited to its needs. The appropriateness of the client's organizational structure depends, in part, on its size and the nature of its activities. The assignment of authority and responsibility pertains to how operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of appropriate management oversight (for example, inadequate supervision or monitoring of accounting personnel, information systems or remote locations).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• A poor structure for assigning ownership of data, including who is authorized to initiate and/or change transactions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Difficulty in determining the organization or individual(s) that control(s) the client.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High turnover of senior management or legal counsel.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of appropriate system of authorization and approval of transactions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Unclear assignment of responsibilities, including those specific to information systems processing and program development.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Policies and procedures for the authorization of transactions are not established at the appropriate level.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

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**Human Resource Policies and Practices**

Human resource policies and practices relate to hiring, orienting, training, evaluating, counseling, promoting, and compensating personnel. These policies and practices also relate to remedial actions, such as disciplining and terminating personnel.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inadequate standards and procedures for hiring, training, motivating, evaluating, promoting, compensating, transferring, or terminating personnel in some or all functional areas (e.g., accounting, marketing, information systems).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• No written job descriptions or reference manuals that inform personnel of their duties (or, in the absence of written documentation, lack of communication of job responsibilities and expectations).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate procedures for establishing and communicating policies and procedures to personnel at decentralized locations (including foreign operations).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Employees with access to cash, securities, and other valuable assets are not bonded.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Policies and procedures are not clear or issued, updated, or revised timely.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of mandatory vacation policy for employees performing key control functions or in areas that lack proper segregation of duties.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Anticipated future employee layoffs that are known to the work force. (There were layoffs by the Company in the 4 <sup>th</sup> quarter of 2002 – no other layoffs expected)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Employees with access to assets susceptible to misappropriation who are known to be dissatisfied.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Known unusual changes in behavior or lifestyle of employees with access to assets susceptible to misappropriation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Known personal financial pressures affecting employees with access to assets susceptible to misappropriation.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

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*Comments and Additional Information*

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

Overall, we believe that management has designed an environment for success. As a result of this environment, management has designed sufficient controls and oversight functions in order to prevent instances of material misstatement of the financial statements. We believe that management is ethical, competent, and fully aware of all potential business developments.

The oversight function of the Company has also been designed to prevent material misstatement of the financial statements. We believe the board of directors and audit committee oversight provides adequate control over management as well as provides adequate direction of the Company. Although Richard Scrusby, CEO, has an overwhelming amount of control over the Company, we feel the results of the Sarbanes-Oxley act have deterred this control through allowing the audit committee more oversight. Note that Mr. Scrusby is not involved with the audit committee.

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### The Client's Risk Assessment Process

Risk assessment is the *client's* process for identifying and analyzing the risks (both internal and external) that are relevant to the achievement of its objectives. In addition, a risk assessment process provides the client with a basis for determining how to manage its risks (e.g., the actions to address specific risks or a decision to accept a risk because of cost or other considerations). After indicating the risk factors in this section that we are aware of that are present, we gain an understanding of the client's risk assessment process, specifically as it relates to the financial reporting objective of internal control, and then we determine, generally through inquiry, observation, and inspection of relevant documents, whether the client's risk assessment process has identified and analyzed each of the risks, and if so, whether the client has implemented appropriate steps to mitigate each of the risks.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
<b>Business and Industry</b>		
• High degree of competition or market saturation, accompanied by declining margins.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Declining industry with increasing business failures.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Rapid changes in the industry, such as significant declines in customer demand, high vulnerability to rapidly changing technology or rapid product obsolescence.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Unusually rapid growth or unusually high profitability, especially compared with those of other companies in the same industry.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<b>Operations</b>		
• Changes in the entity's operating environment.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• New personnel in key financial or operating positions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• New or revamped information systems.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant new lines, products, or activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Unrealistically aggressive sales or profitability incentive programs.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High levels of sales returns.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Corporate restructuring.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Especially high vulnerability to changes in interest rates.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant operations in countries where business practices are questionable.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Small number of transactions that have a material effect on the client.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Assets susceptible to misappropriation; such as large amounts of cash or assets easily convertible into cash; goods in inventory are small in size, high in value, or high in demand; fixed assets are small, marketable, or lack ownership identification.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
<b>Financial Condition</b>		
• Inability to generate cash flows from operations while reporting earnings and earnings growth.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Operating losses or significant deterioration in earnings.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Marginal ability to meet debt repayment requirements (or comply with restrictive loan covenants).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Ability to raise additional capital is limited (e.g., due to high leverage or an inadequate capital base).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Severely deteriorating financial condition or liquidity, or threat of imminent bankruptcy or foreclosure (including when management has personally guaranteed significant debts of the client or when the most recent audit report included, or serious consideration was given to including, a disclaimer or an explanatory paragraph describing an uncertainty about the client's ability to continue as a going concern).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<b>Accounting</b>		
• Assets, liabilities, revenues, or expenses are based on significant estimates that involve unusually subjective judgments or uncertainties (e.g., the timing of revenue recognition or the capitalization of costs), or that are subject to potential significant changes in the near term in a manner that may have a financially disruptive effect on the client.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant, unusual, or highly complex transactions or innovative deals (especially those close to year end) that make the determination of their effects on the financial statements difficult or highly subjective or pose difficult "substance over form" questions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• An extraordinary volume of shipments shortly before or at year end or quarter ends.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the client.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Public criticism or litigation involving accounting, financial reporting, or business practices of the client or of companies in one or more of its industries.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Restatement of the prior year's financial statements for the correction of an error.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Adverse consequences on significant pending transactions, such as a business combination, planned debt or equity issue, or contract award, if poor financial results are reported.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

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*Are the following risk factors present?*

	<u>Yes</u>	<u>No</u>
<b>Related Parties</b>		
• Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Other auditors involved with related entities (or in the annual audit), or some related entities not audited.	<input checked="" type="checkbox"/>	<input type="checkbox"/>

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*Indicate other risk factors considered:*

Class action lawsuits, as well as SEC investigations, are ongoing.

Does the client have a formal risk assessment process? Yes  No . If not, does the client have an informal risk assessment process? Yes  No .

Briefly describe the client's risk assessment process, specifically as it relates to the financial reporting objective of internal control (i.e., preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles):

On a monthly basis, AR is reconciled to the general ledger and bank reconciliations are prepared and reviewed. On a quarterly basis, AP is reconciled to the general ledger. Also on a monthly basis, Facility Administrators, Department Heads, and Corporate Accounting compare current period revenues/expenses to prior period revenues/expenses and to budget.

The PeopleSoft System is configured to map accounts to financial statement line items. Elimination entries/non-standard journal entries are prepared and reviewed for reasonableness. The controller of the Company reviews the consolidating schedules, ensuring that intercompany account balances reconcile.

The CFO and the Controller review the financial statements in conjunction with the E&Y GAAP Disclosure Checklist.

Throughout the year, the HealthSouth Internal Audit Department performs various procedures on the Company's processes. The head of the IA Department reports directly to the HealthSouth Audit Committee.

With respect to the risk factors identified above, has the client's risk assessment process:

- Identified and analyzed each of the risks? Yes  No .
- If yes, has the client implemented appropriate steps to mitigate each of the risks? Yes  No .

*Comments and Additional Information*

Provide additional information about the identified risk factors (and the effectiveness of the client's risk assessment process in addressing and mitigating each of them) to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

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- Due to clarified Mcare regulations, HRC's earnings experienced a sharp decline in the 3<sup>rd</sup> and 4<sup>th</sup> quarter. Their ability to raise additional capital is somewhat limited, due to low stock price and bond rating decline, however, they are still profitable, they have a large amount of cash and they generate significant amounts of operating cash flows.
- During the year, FAS 142 was implemented by the Company. This resulted in a cumulative effect adjustment in the second quarter and will result in an impairment charge at year end due to the decline in operations for the second half of the year as a result of transmittal 1753.
- HRC is involved in multiple shareholder suits related to disclosure of the impact of transmittal 1753 and stock sales by the CEO. In addition, the SEC is also investigating the Company. HRC had a law firm do an investigation stating that there was nothing inappropriate and believe these suits and the investigation by the SEC will find nothing inappropriate.
- Other auditors are involved in the audit of the company's insurance captive. The captive liability is immaterial, however, we marked yes because medical malpractice is a significant account.

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**Control Activities and Information and Communication**

Control activities are the policies and procedures that help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. The information system, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Information and communication is the process of capturing and exchanging the information needed to conduct, manage, and control a client's operations. The quality of the client's information and communication affects management's ability to make appropriate decisions in controlling the client's activities and to prepare reliable financial reports. Information and communication involves capturing and providing information to appropriate personnel so that they can carry out their responsibilities, including providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inability to prepare accurate and timely financial reports, including interim reports.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Planning and reporting systems (such as business planning, budgeting, forecasting, and profit planning; and responsibility accounting) that do not adequately set forth management's plans and the results of actual performance.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate methods of identifying and communicating exceptions and variances from planned performance.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Management's response to reported exceptions and variances is inadequate.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• A low level of user satisfaction with information systems processing, including reliability and timeliness of reports.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Inadequate policies for developing and modifying accounting systems and controls, including changes to and use of computer programs and/or data files.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Overall lack of coordination between the accounting and data processing functions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Understaffed accounting or information technology department, inexperienced or ineffective accounting or information technology personnel, or high turnover.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Lack of timely and appropriate documentation for transactions.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Accounting system is in disarray.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered:*

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*Comments and Additional Information*

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

### Monitoring

Monitoring is the process that assesses the quality of the performance of internal control over time. An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and whether they are modified as appropriate for changes in conditions.

<i>Are the following risk factors present?</i>	<u>Yes</u>	<u>No</u>
• Inadequate monitoring of the continued functioning of significant controls.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Reportable conditions/material weaknesses in internal control (especially when management does not correct them promptly).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Control-related recommendations from internal and/or external auditors are ignored.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• High level of customer complaints (especially when management does not fix the cause of them promptly).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Owner/manager not actively involved in the business.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Significant minority owners (e.g., venture capitalists) and creditors (e.g., banks) do not adequately scrutinize activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Parent company does not adequately scrutinize activities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Oversight by applicable legislative or regulatory bodies, such as examinations by bank regulatory agencies, is ineffective.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
<i>If the client does not have an internal audit function, check here <input type="checkbox"/>, skip the remaining risk factors in this section and consider whether the absence of an internal audit function constitutes a risk factor.</i>		
• Internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent).	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• The scope of internal audit's activities is not appropriate (e.g., balance between financial and operational audits, coverage and rotation of decentralized operations).	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit has limited authority to examine all aspects of the client's operations or fails to exercise its authority.	<input checked="" type="checkbox"/>	<input type="checkbox"/>
• Internal audit does not adequately plan, perform risk assessments, or document the work performed or conclusions reached.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Internal audit does not adhere to professional standards.	<input type="checkbox"/>	<input checked="" type="checkbox"/>
• Internal audit has operating responsibilities.	<input type="checkbox"/>	<input checked="" type="checkbox"/>

*Indicate other risk factors considered.*

*Comments and Additional Information*

Provide additional information about the identified risk factors to assist in determining their effects on the assessments of the effectiveness (ineffectiveness) of internal control at the entity level and the risk of fraud. In addition, you may use this space to provide any comments about any of the other risk factors listed above that you believe those making the assessments need to consider.

Reliance or assistance from the Internal Audit function for HealthSouth does not play an important role in the audit procedures performed by EY. Any information obtained from internal audit is adequately scrutinized and reviewed. We use internal audit assistance in the search for un-entered liabilities, with the FAS 123 calculation, and on site visit procedures.

**Fraud Inquiries**

Comment below on your findings from your inquiries of selected members of management regarding (1) their understanding of the risk of fraud in the entity, and (2) whether or not they have knowledge of any fraud (other than that which is "clearly inconsequential") that has been perpetrated on or within the entity (these inquiries of management are to be made during the early planning stages of the audit by at least a manager):

*Management's understanding of the risk of fraud:*

[Indicate the name(s) and level(s) of the members of management with whom the discussions were held as well as the bases for their responses (e.g., what processes do they employ to provide them with reasonable assurance that their risk assessments are appropriate).]

We held discussions with the following individuals:

Bill Owens – Executive Vice President and Chief Financial Officer

Tadd McVay – Treasurer

Brad Hale – Senior Vice President - Administration and Secretary

Bill Horton – Executive Vice President and Corporate Counsel and Assistant Secretary

Susan Smith – Senior Vice President - Reimbursement

Emery Harris – Group Vice President and Assistant Controller

Management is aware of the risk of fraud within the entity and actively searches for any such instances.

*Management's knowledge of fraud:*

[Indicate the name(s) and level(s) of the members of management with whom the discussions were held as well as the bases for their responses (e.g., what processes do they employ to provide them with reasonable assurance that there are no significant instances of fraud other than those they may have mentioned).]

Management is not aware of any significant instances of fraud. There have been few isolated issues reported through the Corporate Compliance Hotline, but upon follow-up by management, the issues were determined to be minor and not systematic.

Describe any program (not discussed elsewhere in this questionnaire) that the entity may have in place that includes steps to prevent, deter, and detect fraud. If such a program is in place, ask those persons who oversee such program whether the program has identified any fraud or fraud risk factors.

HealthSouth has established an extensive Corporate Compliance Program. Employees are given considerable compliance training. The Company has a "Hotline" available for employees to report fraudulent and/or abusive behavior. The Hotline is monitored by the HealthSouth Internal Audit Department. The Corporate Compliance Officer, Brad Hale, reviews all issues reported through the Hotline. As stated above, upon inquiry of Mr. Hale regarding instances of fraud, he was not aware of any significant issues.

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**Summary and Conclusions**

**Internal Control and Fraud Considerations**

(To be attached to the Audit Strategies Memorandum)

With respect to any risk factors we have identified, describe any controls and/or other factors relating to the client and its business and industry that we are aware of that either mitigate or exacerbate the identified risk factors, and describe the resulting effects of the risk factors on our assessments of internal control at the entity level and the risk of fraud:

We believe the controls and factors that we have outlined above mitigate the identified risk factors in the audit.

The client's internal control at the entity level is  is not  effective. Describe the basis for your conclusion, if it is not obvious:

Describe our audit response(s), if any, to the risk factors we have identified that are not sufficiently mitigated by the client's controls or other factors (or our judgment that our planned audit procedures already constitute a sufficient response to the risk factors):

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During 2002, the following events/risk factors are present:

- All synthetic leases were repurchased (no longer any off balance sheet transactions) – appropriate procedures were designed to test the accounting associated with the synthetic leases.
- Outstanding interest rate swaps were cancelled – EY reviewed accounting for interest rate swaps and cancellation of the swaps.
- MCare released transmittal 1753 that clarified accounting for O/P therapy. HRC announced in August 2002 that the implementation of this transmittal would reduce reimbursement \$175 million annually. This resulted in a drop in the stock price from approximately \$12 to less than \$4. EY designed procedures to test the allowances and the revenue deduction impact of the transmittal
- During the year, the Company paid off debt amounts early resulting in gain on extinguishment of debt – EY designed procedures to review the accounting for this transaction.
- Restructuring / Impairments – As a result of declining revenue, the Company will be closing many facilities and will record a 4<sup>th</sup> quarter loss due to the closings. In addition, FAS 142 is expected to result in a loss in the 4<sup>th</sup> quarter due to the impacts of transmittal 1753. We will review managements calculations and use our valuation experts to assist.
- Investments – HRC has reviewed its investments, and as a result of declines in the market and the economy, certain investments will need to be written down to fair value – EY valuation experts will assist in this review.

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## Tab 83

The minutes related to the March 9, 2000 Board of Directors meeting had not been prepared as of March 23, 2001. Therefore, we inquired of Brad Hale as to the topics discussed during the meeting. A brief outline of the meeting is detailed below:

- Audit Report by E&Y – Dick Dandurand announced his retirement to the board and introduced Jim Lamphron as the new coordinating partner of the engagement. Lamphron stated the audit was substantially complete and no significant audit differences had been found.
- Internal Audit Update – Greg Smith reviewed the prior year internal audit projects, as well as the upcoming schedule. Smith noted that there were no material findings during any of the work performed by IA during the prior year.
- Compliance Update – Brad Hale presented an update of the company's corporate compliance program. He discussed the statistics relating to the compliance hotline (no significant matters were presented). Hale also presented to the board the results of the prior year Pristine Audit projects.
- Financial Highlights – Bill Owens reviewed the financial statistics for the both the year ended and quarter ended December 2000. Owens discussed the implementation of FIN 44 and its effect on the company's earnings. Owens also reviewed the fiscal year 2001 budget.
- Treasury Update – Tad McVay presented more financial highlights of the company. He discussed 4<sup>th</sup> quarter earnings and how earnings fell in line with market estimates. McVay reviewed the changes in debt during the prior year. The liquidity summary was presented. Also, the 2003 financing plan was discussed.
- Chairman's Report – Richard Scrushy gave an overall review of the company. He discussed the strategic outlook of the company and steps necessary to reach its objectives.
- Warburg Dillon Read gave a presentation of recommendations regarding the company's debt and equity structure. Current trends in the market were discussed along with a dialogue of the healthcare industry.
- The presidents of the market lines reviewed operation highlights for the prior year.
- Development Update – Thom Carman gave a prior year update of all acquisitions and the current year strategy. He discussed international highlights and updated the board concerning the potential sale of Richmond and Doctors Medical Centers.
- Political Update – Eric Hanson of US Strategies gave an update of political issues related to the health care industry.
- It was announced that Jan Jones had resigned from the board of directors. Bill Owens was nominated and approved to serve as Jones replacement on the board of directors. Phillip Watkins replaced Jones on the compliance committee.

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant 
Filed by a Party other than the Registrant

Tab 8-4

Check the appropriate box:

- Preliminary Proxy Statement
 CONFIDENTIAL, FOR USE OF THE COMMISSION ONLY (AS PERMITTED BY RULE 14A-6(E)(2))
 Definitive Proxy Statement
 Definitive Additional Materials
 Soliciting Material Pursuant to Rule 14a-11(c) or Rule 14a-12

HEALTHSOUTH CORPORATION

(Name of Registrant as Specified In Its Charter)

HEALTHSOUTH CORPORATION

(Name of Person(s) Filing Proxy Statement)

Payment of Filing Fee (Check the appropriate box):

- No fee required.
 Fee computed on table below per Exchange Act Rules 14a-6(i)(14) and 0-11.

- (1) Title of each class of securities to which transaction applies: N/A
(2) Aggregate number of securities to which transaction applies: N/A
(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11: N/A
(4) Proposed maximum aggregate value of transaction: N/A
(5) Total fee paid: N/A

Fee paid previously with preliminary materials.  Check box if any part of the fee is offset as provided by Exchange Act Rule

0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

- (1) Amount previously paid: N/A
(2) Form, Schedule or Registration Statement No.: N/A

-----  
(3) Filing Party:  
N/A

-----  
(4) Date Filed:  
N/A  
-----

**HEALTHSOUTH CORPORATION  
ONE HEALTHSOUTH PARKWAY  
BIRMINGHAM, ALABAMA 35243**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**

Our 2001 annual meeting of stockholders will be held at One HealthSouth Parkway, Birmingham, Alabama on Thursday, May 17, 2001, beginning at 2:00 p.m., Central Daylight Time. The meeting is being held for the following purposes:

- (1) To elect nine Directors to serve until our next annual meeting of stockholders and until their successors shall have been duly elected and qualified; and
- (2) To act on any other matter that may properly come before the annual meeting or any adjournment(s) or postponement(s) of the annual meeting.

All stockholders of record who own shares of HEALTHSOUTH common stock at the close of business on March 30, 2001 are entitled to receive notice of and to vote at the annual meeting.

----- WHETHER OR NOT YOU INTEND TO ATTEND THE ANNUAL MEETING, PLEASE MARK, DATE, SIGN AND PROMPTLY RETURN THE ACCOMPANYING FORM OF PROXY, USING THE ENCLOSED PREPAID ENVELOPE. IF YOU ATTEND THE ANNUAL MEETING IN PERSON, YOU MAY REVOKE YOUR PROXY AND VOTE IN PERSON. ATTENDANCE AT THE MEETING DOES NOT OF ITSELF REVOKE YOUR PROXY. -----

BRANDON O. HALE  
Secretary

April 17, 2001

**HEALTHSOUTH CORPORATION**

**PROXY STATEMENT**

**INTRODUCTION**

This proxy statement and the accompanying form of proxy are being sent to our stockholders in connection with our solicitation of proxies for use at the 2001 annual meeting of our stockholders or at any adjournment(s) or postponement(s) of the annual meeting. The annual meeting will be held on May 17, 2001, beginning at 2:00 p.m., Central Daylight Time, at our principal executive offices, located at One HealthSouth Parkway, Birmingham, Alabama. We encourage all of our stockholders to vote at the annual meeting, and we hope that the information contained in this document will help

flexibility to reward superior effort and accomplishment even where all cash compensation may not be fully deductible. The Committee will continue to review the requirements for deductibility under Section 162(m) and will take such requirements into account in the future as it deems appropriate and in the best interests of HEALTHSOUTH's stockholders. Approximately \$2,654,849 of Mr. Scrushy's compensation paid with respect to 2000 will not be deductible; however, HEALTHSOUTH believes that all other compensation paid to executive officers will be fully deductible.

<original-page 18 >

#### Conclusion

The Committee believes that the levels and mix of compensation provided to HEALTHSOUTH's executives during 2000 were appropriate and were instrumental in the achievement of the company's goals for 2000. It is the intent of the Committee to ensure that the Company's compensation programs continue to motivate its executives and reward them for being responsive to the long-term interests of HEALTHSOUTH and its stockholders.

The foregoing report is submitted by the following Directors of HEALTHSOUTH, constituting all of the members of the Compensation Committee of the Board of Directors for the year ending December 31, 2000 who continue to serve on the Board of Directors at the date of this Proxy Statement:

John S. Chamberlin  
Larry D. Striplin, Jr., Chairman(1)

-----  
(1) Jan L. Jones, a member of the Compensation Committee in 2000, no longer served on the Board at the date of this Proxy Statement.

#### AUDIT INFORMATION

##### RELATIONSHIP WITH INDEPENDENT PUBLIC ACCOUNTANTS

Our Board of Directors has engaged Ernst & Young LLP to audit our consolidated financial statements for the fiscal year ended December 31, 2000. We expect that Ernst & Young LLP will serve in that capacity for the 2001 fiscal year as well. We expect that representatives of Ernst & Young LLP will be present at the annual meeting to make a statement if they desire to do so and to respond to appropriate questions.

##### AUDIT FEES

The aggregate fees billed to us for the fiscal year ended December 31, 2000 by Ernst & Young LLP for the fiscal year ended December 31, 2000 or related to its audit for such fiscal year were as follows:

Audit Fees .....	\$1,026,649
All Other Fees .....	
Audit-Related Fees .....	\$2,583,854
Non-Audit-Related Fees .....	66,107
	-----
Total of All Other Fees ...	\$2,649,961

##### AUDIT COMMITTEE REPORT

The Audit Committee of the Board of Directors, consisting of C. Sage Givens, Larry D. Striplin, Jr. and George H. Strong, Chairman, is responsible for overseeing HEALTHSOUTH's financial reporting process on behalf of the Board of Directors. HEALTHSOUTH's management has the primary responsibility for the financial statements and the reporting process, including the systems of internal control. In fulfilling its oversight responsibilities, the Committee reviewed the audited financial statements contained in HEALTHSOUTH's Annual Report on Form 10-K for the Fiscal Year Ended December

## Tab 85

Audit Fees for Proxy Disclosure  
2000 Year End

	2000	2001
<b>Audit Fees</b>		
Annual Audit	939,400	1,071,000
Quarterly Reviews	87,249	93,750
<b>Total Audit Fees</b>	<u>1,026,649</u>	<u>1,164,750</u>
<b>All Other Fees</b>		
Audit Related Fees		
Pristine Audits	1,250,000	1,332,261
HIPAA Readiness Assessment	476,333	
Florida and Puerto Rico Statutory Audits	355,300	343,725
Partnership Audits		
Kansas	70,000	46,900
Portland	46,000	28,750
Any other Partnership Audits		
Symmes	3,027	
Memphis	14,400	
	<u>133,427</u>	<u>75,650</u>
UK Statutory Audits (US\$)	48,827	47,678
Other Attest Work		
Chesapeake Agreed Upon Procedures	19,400	21,650
CMS Litigation Support	14,000	
Daly City and Australia	1,536	
Internal Audit - Australia		22,000
Penn State Geisenger Review/Audit	4,750	29,500
Horizon 401K audit	13,000	6,750
Newport Beach Election Count	2,000	
	<u>54,686</u>	<u>79,900</u>
Registration Work	117,525	146,625
SCA Development Audit	53,575	38,124
FACIS	47,916	
Other Accounting and Consultation	40,015	28,923
Oracle System Control Assessment		288,540
AABSCAST	6,250	6,250
	<u>2,583,854</u>	<u>2,387,676</u>
All Other Fees Excluding Audit Related		
US Tax	19,762	75,215
UK Tax (US\$)	46,345	46,365
	<u>66,107</u>	<u>121,580</u>
<b>Total "All Other" Fees</b>	<u>2,649,961</u>	<u>2,509,256</u>
<b>Total Fees</b>	<u><u>3,676,610</u></u>	<u><u>3,674,006</u></u>

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CONFIDENTIAL

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**Appendix 1:**  
**Summary of Fees (Proxy Disclosure Format)**


---

	2000 Actual
<b>Audit Fees<sup>1</sup></b>	
Annual Audit	\$ 939,400
Quarterly Reviews	87,249
<b>Total Audit Fees</b>	<u>1,026,649</u>
<b>All Other Fees</b>	
Audit Related Fees <sup>2</sup>	2,583,854
All Other Fees Excluding Audit Related <sup>3</sup>	66,107
<b>Total "All Other" Fees</b>	<u>2,649,961</u>
<b>Total Fees</b>	<u>\$ 3,676,610</u>

<sup>1</sup> The amounts in this category include fees for the audit of the Company's 2000 financial statements, regardless of when the services are performed and billed.

<sup>2</sup> Audit related services principally include fees related to pension, statutory and subsidiary stand-alone audits; the Pristine Audits; consultation on accounting standards; SEC registration statements; and a Health Insurance Portability and Accountability Act (HIPAA) assessment.

<sup>3</sup> All other primarily relates to tax related services.

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**Attachment - Summary of Fees (Proxy Disclosure Format)**


---

	2001 Actual
<b>Audit Fees<sup>1</sup></b>	
Annual Audit	\$ 1,071,000
Quarterly Reviews	93,750
<b>Total Audit Fees</b>	<u>1,164,750</u>
<b>All Other Fees</b>	
Audit Related Fees <sup>2</sup>	2,387,676
All Other Fees Excluding Audit Related <sup>3</sup>	121,580
<b>Total "All Other" Fees</b>	<u>2,509,256</u>
<b>Total Fees</b>	<u>\$ 3,674,006</u>

<sup>1</sup> The amounts in this category include fees for the audit of the Company's 2001 financial statements, regardless of when the services are performed and billed.

<sup>2</sup> Audit related services principally include fees related to pension, statutory and subsidiary stand-alone audits; the Pristine Audits; consultation on accounting standards; SEC registration statements; and a systems controls review assessment related to the potential implementation of Oracle software solutions.

<sup>3</sup> All other primarily relates to tax related services.

EYDF 003835  
CONFIDENTIAL

**Audit Fees**

The aggregate fees billed to us by Ernst & Young LLP for the fiscal year ended December 31, 2001 c  
audit of such fiscal year were as follows:

Audit Fees	1,164,750
All Other Fees	
Audit Related Fees	2,387,676
Non-Audit Related Fees	<u>121,580</u>
Total of All Other Fees	2,509,256

Wayne -

See attached comments re #5 . It w/b  
great if they/us would address the reporting  
implications early.

J 1/31/02

### MD&A Disclosure of Critical Accounting Policies—Implementation Guidance

On December 12, 2001, the SEC issued a financial reporting release, FR-60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (FR-60). The SEC's Cautionary Advice alerts public companies to the need for improved disclosures about critical accounting policies. FR-60 defines "critical accounting policies" as those most important to the financial statement presentation and that require the most difficult, subjective, complex judgments. The SEC expects public companies to provide disclosures responsive to FR-60, including MD&A disclosures, in their 2001 annual reports.

#### Critical Accounting Policies—SEC Expectations

**MD&A:** A primary focus of the FR-60 is the need for more discussion in MD&A about critical accounting policies. The SEC believes that MD&A should make investors aware of the sensitivity of financial statements to the methods, assumptions and estimates underlying the financial statements. Specifically, FR-60 states, "We encourage public companies to include in their MD&A full explanations, in plain English, of their 'critical accounting policies,' the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions" (emphasis added). Clearly, the SEC believes such disclosure is consistent with the objective of MD&A. FR-60 also suggests that MD&A would be enhanced by an explanation of the interplay of identified uncertainties with accounting measurements in the financial statements.

**GAAP Footnote Disclosures:** FR-60 reminds registrants of the existing GAAP requirements for disclosures of accounting policies (APB Opinion No. 22) and the risks and uncertainties inherent in significant estimates (AICPA SOP 94-6). FR-60 indicates that the SEC intends to consider new rules later this year to require "more precise disclosures" about critical accounting policies.

**Financial Reporting Process:** FR-60 states that management should be able to defend the quality and reasonableness of the critical accounting policies, and auditors should satisfy themselves thoroughly regarding the policies' selection, application and disclosure. Also, the audit committee, through discussion with management and the auditor, should review the selection, application and disclosure of critical accounting policies prior to the company filing its annual report. In the interests of addressing problems before they happen, the SEC encourages consultation with the SEC staff if registrants, audit committees or auditors are uncertain about the application of specific aspects of GAAP.

**Implementation Considerations**

This publication provides guidance to assist companies in their implementation of FR-60 as it relates to the discussion in MD&A of their critical accounting policies.

**Different Assumptions and Conditions:** FR-60 calls for MD&A discussion of critical accounting policies, the related judgments and uncertainties associated with the application of those accounting policies, and the sensitivity of the amounts reported in the financial statements to material changes were different conditions and assumptions to apply. Although the SEC staff has not provided interpretive guidance on the meaning of "different assumptions and conditions," we believe the spirit of this disclosure would limit alternative assumptions to those that are reasonably plausible and are supportable by evidence that is comparable to evidence used by management to support the assumptions selected. For example, different assumptions would include differences in opinions/judgments that, when evaluated by a reasonable businessperson, would hold similar levels of acceptability. Similarly, different conditions should include those that could be reasonably expected to have occurred considering the economic, business and regulatory environments, the financial condition of counterparties to agreements, and expectations of future events (e.g., default rates and sales returns).

**Content and Location:** In making disclosures under FR-60, registrants need not repeat information that is included in the financial statements or elsewhere in the company's MD&A. Accordingly, the disclosures are not intended to replace required GAAP disclosures in the financial statements or MD&A disclosure required under other SEC rules (e.g., disclosures of environmental matters). In addition, registrants need not establish a separate section of MD&A to disclose this information although some companies may wish to do so. Regardless of whether the MD&A includes a separate caption for critical accounting policies, we expect most companies will provide the MD&A discussion of critical accounting policies in one location.

The SEC expects companies to disclose the likelihood that materially different amounts would be reported under different assumptions and conditions. We believe this may be accomplished through either qualitative or quantitative means. For example, quantitative disclosure could be made of the impact on financial condition or results of operations had the company used reasonably plausible differences in assumptions or estimates (i.e., a sensitivity analysis). Alternatively, a company could discuss qualitatively the effects on financial results had underlying estimates or conditions been more or less favorable.

**Identification of Critical Accounting Policies:** Companies should carefully evaluate their financial statements to determine the most critical accounting policies. While many accounting policies are important to the presentation of the financial statements, we believe that "critical accounting policies" would be no more than a handful of accounting policies where the related financial statement amounts are most sensitive to material variation. The most critical accounting policies would be those where material

*I would expect  
H/S to have  
a new section  
in MD&A  
labeled "critical  
acct. policies +  
estimates."*

*let's discuss  
these up front  
& see if we  
can tell H/S  
what we consider  
to be the most  
sensitive (i.e.  
min. disclosure)*

*all synthetic lease transactions have to be disclosed.*

MD&A Disclosure of Critical Accounting Policies—Implementation Guidance  
January 2002

differences could have occurred if management had used different, but nonetheless reasonably plausible, assumptions and estimates or if different, but nonetheless reasonably plausible, conditions occurred in the current period. Due to the uniqueness of each company, their industry, and the use of estimates and assumptions in their financial statements, some companies may have one or two critical accounting policies while other companies may have numerous critical accounting policies.

To assist in identifying potentially critical accounting policies, Attachment A provides a listing of accounting policies and the related judgments and uncertainties normally associated with their application. Companies that have related party transactions, utilize off balance sheet arrangements (particularly involving special purpose entities), or that trade in non-exchange traded commodity contracts accounted for at fair value should be aware that the SEC is very focused on disclosures of such matters in 2001 annual reports.

**Clarity:** FR-60 disclosures in MD&A should be written in plain English such that an average investor will understand the extent to which assumptions and conditions impact the financial statements as well as the sensitivity of reported amounts to changes in those assumptions and conditions. The SEC has made it clear that **FR-60 disclosures should not be:**

- risk factors applicable to all companies in a given industry or environment;
- boilerplate disclosures that do not specifically address the reporting company's unique operations; or
- laundry lists of accounting policies for all material line items in the company's financial statements.

**Summary**

While it may be relatively late in the year-end 2001 financial reporting process, we believe that it is important to focus on improved disclosures of the most difficult and judgmental estimates, the most important and pervasive accounting policies, and the areas most sensitive to material change from external factors. We hope that you find this document useful as you develop your own MD&A disclosures about your critical accounting policies.

*the "bar" is being lowered "this yr. so it may be that RPT that weren't reported in the past due to materiality considerations may be disclosed in footnotes this year"*  
*For audit doc. purposes - we need a comprehensive list of all RPT's and comb. and clean doc. as to which ones would be disclosed + why. Such PBC list shd be audited!*  
*(3/19)*

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant  Tab 87  
Filed by a Party other than the Registrant

Check the appropriate box:  
 Preliminary Proxy Statement  
 CONFIDENTIAL, FOR USE OF THE COMMISSION ONLY (AS PERMITTED BY RULE 14A-6(E)(2))  
 Definitive Proxy Statement  
 Definitive Additional Materials  
 Soliciting Material Pursuant to Rule 14a-11(c) or Rule 14a-12

HEALTHSOUTH CORPORATION  
-----  
(Name of Registrant as Specified In Its Charter)

HEALTHSOUTH CORPORATION  
-----  
(Name of Person(s) Filing Proxy Statement)

Payment of Filing Fee (Check the appropriate box):  
 No fee required.  
 Fee computed on table below per Exchange Act Rules 14a-6(i)14 and 0-11.

(1) Title of each class of securities to which transaction applies: N/A  
-----

(2) Aggregate number of securities to which transaction applies: N/A  
-----

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11:  
N/A

(4) Proposed maximum aggregate value of transaction:  
N/A

(5) Total fee paid: N/A  
-----

Fee paid previously with preliminary materials. -----  Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount previously paid:  
N/A  
-----  
(2) Form, Schedule or Registration Statement No.:

N/A

(3) Filing Party:

N/A

(4) Date Filed:

N/A

**HEALTHSOUTH CORPORATION  
ONE HEALTHSOUTH PARKWAY  
BIRMINGHAM, ALABAMA 35243**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**

Our 2002 annual meeting of stockholders will be held at One HealthSouth Parkway, Birmingham, Alabama on Thursday, May 16, 2002, beginning at 2:00 p.m., Central Daylight Time. The meeting is being held for the following purposes:

- (1) To elect nine Directors to serve until our next annual meeting of stockholders and until their successors shall have been duly elected and qualified; and
- (2) To act on any other matter that may properly come before the annual meeting or any adjournment(s) or postponement(s) of the annual meeting.

All stockholders of record who own shares of HEALTHSOUTH common stock at the close of business on March 28, 2002 are entitled to receive notice of and to vote at the annual meeting.

----- WHETHER OR NOT YOU INTEND TO ATTEND THE ANNUAL MEETING, PLEASE COMPLETE, DATE, SIGN AND PROMPTLY RETURN THE ACCOMPANYING FORM OF PROXY, USING THE ENCLOSED PREPAID ENVELOPE. IF YOU ATTEND THE ANNUAL MEETING IN PERSON, YOU MAY REVOKE YOUR PROXY AND VOTE IN PERSON. ATTENDANCE AT THE MEETING DOES NOT OF ITSELF REVOKE YOUR PROXY. -----

BRANDON O. HALE  
Secretary

April 12, 2002

**HEALTHSOUTH CORPORATION**

**PROXY STATEMENT**

**INTRODUCTION**

This proxy statement and the accompanying form of proxy are being sent to our stockholders in connection with our solicitation of proxies for use at the 2002 annual meeting of our stockholders or at any adjournment(s) or postponement(s) of the annual meeting. The annual meeting will be held on May 16, 2002, beginning at 2:00 p.m., Central Daylight Time, at our principal executive offices, located at One HealthSouth Parkway, Birmingham, Alabama. We encourage all of our stockholders to vote at the annual meeting, and we hope that the information contained in this document will help you decide how you wish to vote at the annual meeting. These proxy solicitation materials are being sent to our stockholders on or about April 12, 2002.

The foregoing report is submitted by the following Directors of HEALTHSOUTH, constituting all of the members of the Compensation Committee of the Board of Directors for the year ending December 31, 2001 who continue to serve on the Board of Directors at the date of this Proxy Statement:

John S. Chamberlin  
 Phillip C. Watkins, M.D.  
 Larry D. Striplin, Jr., Chairman

**AUDIT INFORMATION**

**RELATIONSHIP WITH INDEPENDENT PUBLIC ACCOUNTANTS**

Our Board of Directors has engaged Ernst & Young LLP to audit our consolidated financial statements for the year ended December 31, 2001. We expect that Ernst & Young LLP will serve in that capacity for the 2002 fiscal year as well. We expect that representatives of Ernst & Young LLP will be present at the annual meeting to make a statement if they desire to do so and to respond to appropriate questions.

**AUDIT FEES**

The aggregate fees billed to us for the fiscal year ended December 31, 2001 by Ernst & Young LLP for the fiscal year ended December 31, 2001 or related to its audit for such fiscal year were as follows:

Audit Fees .....	\$1,164,750
All Other Fees .....	
Audit-Related Fees .....	\$2,387,676
Non-Audit-Related Fees .....	\$ 121,580

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**AUDIT COMMITTEE REPORT**

The Audit Committee of the Board of Directors, consisting of C. Sage Givens, Larry D. Striplin, Jr. and George H. Strong, Chairman, is responsible for overseeing HEALTHSOUTH's financial reporting process on behalf of the Board of Directors. HEALTHSOUTH's management has the primary responsibility for the financial statements and the reporting process, including the systems of internal control. In fulfilling its oversight responsibilities, the Committee reviewed the audited financial statements contained in HEALTHSOUTH's Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2001 with management, including a discussion of the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of disclosures in the financial statements.

All members of the Audit Committee are "independent" under the standards established by the New York Stock Exchange. A copy of the Audit Committee charter is included as Appendix B to this Proxy Statement.

The Committee reviewed with the independent auditors, who are responsible for expressing an opinion on the conformity of those audited financial statements with accounting principles generally accepted in the United States, their judgments as to the quality, not just the acceptability, of HEALTHSOUTH's accounting principles and such other matters as are required to be discussed with the Committee under generally accepted auditing standards. In addition, the Committee has discussed with the independent auditors the auditors' independence from management and HEALTHSOUTH, including the matters in the written disclosures required by the Independence Standards Board, and considered the compatibility of non-audit services with the auditors' independence. The Committee believes that the non-audit services are compatible with such independence.

The Committee discussed with HEALTHSOUTH's internal and independent auditors the overall scope and plans of their respective audits. The Committee meets with the internal and independent auditors, with and without management present, to discuss the results of their examinations, their evaluations of HEALTHSOUTH's internal controls, and the overall quality of HEALTHSOUTH's financial reporting.

Significant Transactions for 2002 audit  
HRC

Tab 88

1<sup>st</sup> Quarter

Building Swap - In the first quarter of 2002, HealthSouth exchanged two inpatient facilities for five nursing home facilities in order to complete the sale of the Greenery Nursing homes – the transaction resulted in an immaterial loss.

2<sup>nd</sup> Quarter

Sale of Greenery Nursing Facilities - In the second quarter of 2002, HealthSouth recorded a loss on the sale of the five Greenery Nursing Homes to Senior Residential Care, Inc. (SRC). The transaction closed in June of 2002. Net assets of approximately \$87 million were sold for a loss of approximately \$76.7 million.

Interest Rate Swap - On 5/30/02, the company entered into two \$250 million interest rate swaps, which effectively swapped \$500 million of the \$1 billion Senior Notes issued in May of 2002. The reasoning behind the swap was for immediate interest savings and to improve the company's mix of fixed/variable interest rates.

Write-off of Loan Fees Associated with the 1998 Revolving Credit Facility - On May 22, 2002, HealthSouth paid off the 1998 Revolving Credit Facility with proceeds from the \$1 billion Senior Notes issued in May of 2002. There were approximately \$5.5 million of loan fees associated with the credit facility that were not amortized as of 6/30/02. These loan fees were written off and charged to operations under FAS 145 (early adopted by the company).

Purchase of Properties under Synthetic Leases - During the second quarter of 2002, HealthSouth exercised their option to purchase the properties under their Synthetic Leases – the Digital Hospital, the Corporate Office and nine rehabilitation hospitals.

Transitional FAS 142-June 30 - The company adopted FAS 142 on 1/1/02. The company completed the evaluation of goodwill at December 31, 2001 and recognized a goodwill impairment of \$83,165,000, net of tax of \$31,877,000. The effects of the impairment are reflected as the cumulative effect of a change in accounting principle in the results of operations for the six months ended 6/30/02. The company utilized independent appraisers in conducting this evaluation. With the help of the E&Y Valuation Specialists in Atlanta, we reviewed the evaluation performed by the independent appraisers and noted no material or significant issues.

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**3<sup>rd</sup> Quarter**

Interest Rate Swap termination - On August 5, 2002, HRC terminated the aforementioned interest rate swaps in exchange for cash paid to HRC of \$23 million. The gain is being amortized over the remaining life of the Notes.

Gain on extinguishment of debt - At various dates throughout the third and fourth quarter, HRC retired approximately \$445 million in debt at discounted rates. The company recognized a gain on early extinguishment of debt of \$25 million.

Stock buyback (Treasury Stock) - During the third quarter HRC repurchased \$31 million of its common stock. Included in this amount were approximately 2.5 million shares valued at approximately \$25 million previously owned by Richard Scrusby, Chairman of the Board. The proceeds, from this repurchase, were used by Mr. Scrusby to pay back a \$25 million loan to the Company.

Investment Activity - During the quarter, HRC sold its stock holdings in Caremark. HRC held 1,680,500 shares valued at \$27 million. The sale resulted in a gain of approximately \$16 million. Also during the quarter, HRC determined that its investment in Summerville was impaired and wrote off its \$13 million investment.

**4<sup>th</sup> Quarter**

Restructuring Charge - As a result of poor operating performance in certain facilities, HRC made a decision to close or sale approximately 220 facilities. A charge of approximately \$255 million was taken in the quarter to write these assets down to their realizable value and to account for certain exit costs.

FAS 144 Impairment - The Company performed their normal impairment review (similar to FAS 121) and as a result of future cash flows not supporting fixed asset values, HRC wrote down fixed assets by approximately \$49 million. In addition, the Company is planning to dispose of some of their aircraft and have recorded an impairment of approximately \$7 million to write these assets down to their fair value.

FAS 142 impairment - The Company performed their FAS 142 calculation as of 12/31/02. The calculation resulted in additional impairment of goodwill of approximately \$80 million.

Accounts receivable Allowances - During the Company's review of year-end allowance balances, they noted that account receivable allowances were understated by approximately \$110 million. This was due to many factors - better systems to analyze A/R, quicker collection of receivables, writing off older receivables. The allowances deteriorated slightly in the third quarter (approximately \$34 million based on hindsight performed at year-end), but this was masked by the expected improvements in I/P A/R due to PPS. HRC is initiating procedures on quarterly reviews to more accurately estimate allowances.

Retroactive Settlements – The 12/31/01 cost reports for LP rehabilitation are the last cost reports to be filed under cost-based reimbursement. The Company's model for estimating settlements was overstating amounts due and this was revealed when the model was no longer used – HRC recorded a change in estimate of \$50 million.

Investment Activity – During the quarter, HRC evaluated their investment portfolio and noted many cost-basis investments were stated above fair value. These included FitLinxx, Stonebridge Technologies, and a couple of JV funds – these were written down to their market value resulting in a loss of approximately \$6 million

In addition, HRC has an investment in Source Medical which is an equity method investment. During 2002, Source Medical experienced significant losses and HRC recorded their share of the losses of approximately \$6 million. Also, there were ongoing discussions related to the Company's receivables from Source Medical. Resolution was made on outstanding receivable amounts and the Company wrote off an additional \$4 million.

HRC's investment in MCD was an equity method investment. HRC provided an advance of \$10 million to MCD during 2002. This is considered a funding of previous losses. This funding in addition to the debt guarantee provided by HRC to MCD results in writing the investment in MCD down for all years that had not been previously written down – amount - \$11 million

OrthoRX equity method investment – write down for HRC's % of losses - \$3 million

Meadowbrook Healthcare purchase price adjustment of \$13 million

Scrushy and Tanner Employment Agreements – Based on review of employment agreements for Scrushy and Tanner from April 1998, we noted that no accrual had been booked for their retirement benefits. An adjustment of \$18 million was made to record the Company's current liability.

In addition, Scrushy's agreement calls for the extension of option term on his retirement – current compensation expense related to this would be \$93 million

Risk Factors  
12/31/02 Year-end HealthSouth audit

Economy

- Market Decline
- Increases in Unemployment
- Cost cutting efforts by the government
- Pressure on providers to control costs

Accounting – EY

- SEC Leadership changes
- Public Accounting Oversight Board
- Sarbanes-Oxley Act
- Post-Enron Environment
- New Accounting Standards – 142, 144

HealthSouth

- Litigation/Shareholder suits
- SEC investigation
- SEC 10-K, 10-Q reviews
- PPS on inpatient rehabilitation
- Final cost reports for I/P rehab under cost-based reimbursement
- Surgery Center transaction / cancellation
- Transmittal 1753
- Changes in management – CEO / COO / CFO
- Low stock price
- Restructuring / cost cutting
- Turnover in the audit committee

Audit Committee Topics  
HRC  
3/7/03

- 1) Approve DSH project
- 2) Status of tax project approved at previous meeting
- 3) Audit Status
  - a. Confirms
  - b. Memos from management
  - c. FAS 142 – awaiting final actuary report
  - d. FAS 142 – total FAS 142 expense is coming down from \$80 million in press release
  - e. Minority interest adjustment related to allowance adjustment of \$110 million – approximately \$45 million related to surgery centers
- 4) Questions
- 5) Timing of 10-K, telephonic meeting with Audit Committee – 3/21/03 filing date
- 6) April meeting for Sarbanes-Oxley Rule 404

## What Ernst Did for HealthSouth

Proxy Document Says Company Performed Janitorial Inspections Misclassified as Audit-Related

By JONATHAN WEIN

**E**RNST & YOUNG LLP collected \$2.6 million from HealthSouth Corp. for consulting janitorial services in 2000 and 2001, according to a proxy document filed with the company's facilities in 2000 and 2001 and advised it to classify the payments as "audit-related fees," according to HealthSouth, to make its corporate public filings about Ernst & Young's fees for audit services.

The brainchild of former HealthSouth Chairman and Chief Executive Richard Scruby, the company's janitorial services are called "Pristine Audits." Despite the name, these reviews had nothing to do with Ernst's audits of the company's financial statements. Rather, they were meant to check the cleanliness and physical appearance of HealthSouth's approximately 1,800 surgical and rehabilitation facilities.

The program, Ernst made unannounced visits to each facility once a year, using dozens of junior-level accountants who were trained for the inspections at HealthSouth's Birmingham, Ala., headquarters. Ernst made unannounced visits armed with a 50-point checklist designed by Mr. Scruby. The checklist included seeing if magazines in waiting rooms were orderly, the tiled floors were clean and if there were no stains. The checklist also included seeing if all receipts had had liners. HealthSouth paid Ernst more money to inspect its facilities than it did to audit its books.

Ernst's former chairman, Donald Koverth, says: "EY believes that HealthSouth's fees were properly classified." He declined to comment when asked how the pristine audits were related to Ernst's financial audits. He says that Ernst's new management team takes a different view. "HealthSouth relied on Ernst & Young to



The disclosures have prompted proxy filings to HealthSouth's shareholders, which must be prepared to be independent in audits with so much other business at stake.

Many companies, encouraged by SEC audit rules, have been reluctant to disclose how much of their fees for "other services" are "audit-related." The SEC's 2000 rules didn't envision this practice, or defining them as "audit-related" in the first place. The proxy for a proxy to use the term "audit-related" in a false and misleading way. More common ex-

Please Turn to Page C5, Column 1

## 'Audit-Related Fees' to Ernst Were for Janitorial Inspections

*Continued From Page C1*

amples of audit-related services include pension-plan audits and consultations on accounting rules. "Pristine audits" previously had been unheard of, according to accounting-industry executives.

HealthSouth's April 2001 proxy, filed with the SEC, said the company paid Ernst \$1.03 million to audit its 2000 financial statements and \$2.65 million of "all other fees." The proxy said the other fees included \$2.35 million of "audit-related fees," and \$66,107 of "nonaudit-related fees." In its April 2002 proxy, HealthSouth said it paid Ernst \$1.16 million for its 2001 audit and \$2.51 million for "all other fees." The proxy said the other fees included \$2.35 million for "audit-related fees" and \$121,580 for "nonaudit-related fees."

Neither proxy described in any detail the audit-related or nonaudit-related services for which Ernst was paid. Mr. Brimmer, the HealthSouth spokesman, says the audit-related-fee figures for each year included about \$1.3 million for the pristine audits.

Mr. Scrushy was fired by HealthSouth's board in March, as was Ernst, shortly after the first of 11 former HealthSouth executives pleaded guilty to felony charges over an accounting fraud that overstated profits by \$2.5 billion. In a civil complaint, the SEC has accused Mr. Scrushy of participating in the fraud. Prosecutors are considering whether to file criminal charges against him. Last month, in a victory for Mr. Scrushy, a federal judge denied an SEC request to freeze Mr. Scrushy's assets. Through his attorneys, Mr. Scrushy has denied wrongdoing.

HealthSouth hasn't filed its 2003 proxy or its 2002 year-end financial statements, as a result of the ongoing investigations. Mr. Brimmer said HealthSouth paid Ernst \$5.4 million for 2002, including \$1.1 million for financial-statement audit services and \$1.4 million for the pristine audits. Upon firing Ernst, HealthSouth discontinued the pristine audits.

The government's fraud complaints against former HealthSouth executives haven't cited the pristine audits. But the program illustrates how Ernst had become an instrument of HealthSouth's marketing machine when it was supposed to be acting as the company's financial watchdog. Mr. Scrushy touted the company's nearly perfect pristine-audit scores at public appearances. Ernst says its auditors had been unaware of HealthSouth's accounting deceptions.

Describing the pristine audits at a Feb. 5, 2003, investor conference, Mr. Scrushy said: "We believe one of the reasons that we have done so well has to do with the fact that we do audit all of our facilities, 100%, annually. And we use an outside audit firm, our auditors, Ernst & Young. They visit all our facilities, 100%."

On its Web site, HealthSouth said the pristine audit, "administered independently by Ernst & Young LLP... ensures that all of our patients enjoy a truly pristine experience during their time at HealthSouth. The average score was 98 percent, with more than half of our facilities scoring a perfect 100 percent."

Thomas Sjoblom, an attorney for Mr. Scrushy, says the pristine audits were aimed at providing better care for HealthSouth patients. "The intent was not to use Ernst & Young as part of its marketing program," Mr. Sjoblom says.

Critics question the wording of the proxy disclosures. "E&Y arguing that checking the cleanliness of a facility is 'audit related' goes well beyond the pale of sanity and common sense," says Lynn Turner, the SEC's chief accountant from 1996 until 2001.

Walter Schuetze, another former SEC chief accountant, says Ernst should stop

"Calling that audit-related is false and misleading," Mr. Schuetze says. "Not only does it fly in the face of facts. It suggests that Ernst & Young was covering up the facts.... When Ernst & Young deliberately misclassifies something that is clearly on its face wrong, that undermines everything Ernst & Young says and does."

The responsibility for the accuracy of proxy disclosures lies with the companies that prepare them. However, Mr. Brimmer points to a March 2002 report by Ernst to HealthSouth's management and board, covering Ernst's services for the fiscal year ended Dec. 31, 2001. The report included an attachment that summarized Ernst's fees and provided a suggested "Proxy Disclosure Format." The attachment shows that Ernst classified the pristine audits as "audit-related services" and the fees for them as "audit-related fees."

Mr. Howarth, the Ernst spokesman, declines to comment on Ernst's proxy-disclosure advice. In a statement, he says Ernst "for the most part" used "audit personnel who were not members of the HealthSouth audit-engagement team" to conduct the pristine audits. Therefore, he says, "the program did not detract from the work done by Ernst & Young on the audits of HealthSouth's financial statements." Mr. Howarth adds: "At the time of HealthSouth's disclosures, there were no SEC rules that defined audit-related services. Describing operational audit procedures as audit-related services was reasonable."

Donald Watkins, a lawyer for Mr. Scrushy, says shareholders could have asked about Ernst's services at HealthSouth's annual meetings, but that SEC rules didn't require the company to describe them in its proxies. "That ain't required by nobody at any time," he says.

Among other items on the 50-point checklist: check the walls, furniture, floors and whirlpool areas; for stains; check that the heating and cooling vents "are free of dust accumulation"; that the "floors are free of trash"; and that the "overall appearance is sanitary."

Clean laundry was to be neatly folded and stored, while soiled laundry was to be stored "in a covered container," the checklist said. Ernst accountants also had to make sure the facilities' soft-drink machines distributed Coca-Cola Co. products. In 1997, HealthSouth and Coke signed a five-year, exclusive agreement for Coke to provide its beverages at HealthSouth facilities.

A small portion of the checklist pertained to money matters, though none of it pertained to accounting. Assignments included checking if petty-cash drawers were secure and company equipment was properly tagged. The checklists didn't cover insurance-billing procedures or the quality of the medical treatment.

According to the company's self-published book, "The Story of HealthSouth," Mr. Scrushy got the idea for facility inspections one day in 1996 while lying in bed, worried about keeping HealthSouth's facilities spotless and friendly. He assigned HealthSouth internal auditor Theresa Sanders that year to work out the details. Ms. Sanders testified at a court hearing this spring. Asked by the judge at the hearing whether the pristine audits were related to HealthSouth's audits, Ms. Sanders, who left the company in 1999, said: "No ma'am. This was a totally separate thing."

—Carrick Mollenkamp  
contributed to this article.

Journal Link: [WSJ.com](http://WSJ.com)  
subscribers can see copies of  
HealthSouth's "Pristine Pacto"  
checklists for inpatient and outpatient

WSJ 4/11/03  
Page 523  
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**HEALTHSOUTH Corporation**  
**MEETING OF THE BOARD OF DIRECTORS**  
**FEBRUARY 7, 2003**

**MINUTES**

**Tab 90**

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated February 7, 2003, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, John S. Chamberlin, George H. Strong, Charles W. Newhall III, C. Sage Givens, Joel C. Gordon, Larry D. Striplin, Jr., Jon F. Hanson and Robert P. May. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, and William W. Horton, Executive Vice President and Corporate Counsel of the Corporation. Joining Mr. Scrusby in his offices were Messrs. Striplin, Horton and Hale. All others participated in the meeting via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 12:35 p.m. C.S.T.

**Legal Update**

Messrs. Scrusby and Horton provided the Board with an update on events involving the U.S. Attorney's Office investigation, which appears to be centered around individuals who traded HEALTHSOUTH securities during the summer of 2002. Mr. Scrusby reviewed press coverage to date on the investigation and stated that agents have not been at the Corporate headquarters. Mr. Horton added that the investigation appears at present to be driven by the local U.S. Attorney's Office and that no one individual has been identified as a subject or target of the investigation.

**HHEC 18-02367**

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Mr. Hanson asked Mr. Horton whom the Special Litigation Committee should contact regarding their subpoena from Delaware. He was advised by Mr. Horton to follow the direction of Lee Zell with Balch & Bingham, counsel to the Special Litigation Committee.

Mr. Scrushy informed the Board that the Corporation had received a favorable ruling from the judge on litigation regarding HEALTHSOUTH's construction of the digital hospital. He advised that HEALTHSOUTH would have a press release when given clearance by its attorneys in Montgomery.

**Financial Update**

Mr. Scrushy updated the Board on January operating results, stating that revenues were \$47 million above budget, with good Medicare mix and positive trending across product lines. Mr. Scrushy added that the morale and attitude of the employees was good and that news of the U.S. Attorney's investigation did not appear to be negatively affecting referral sources.

**Nominating/Corporate Governance Report**

Mr. May updated the Board on the search for new Directors, stating that two candidates were interviewed last week and two to four additional interviews were scheduled for next week. He advised that the draft of the Corporate Governance Guidelines was close to being completed. Mr. May also expressed concern over not yet receiving revised Board Minutes.

**Other Business**

Mr. Scrushy advised the Board that he and Mr. Strong met with the search firm leading the Corporation's search for a COO and that the process is in motion.

Mr. Scrushy also advised the Board that he was seeking approval from the Board to leave Dr. Watkins' stock options open until their normal expiration date as part of his agreement to be available to consult with the Board on an as needed basis. After discussion, upon motion duly made by Mr. Striplin and seconded by Mr. Newhall, the following motion was approved, with Mr. Gordon abstaining:

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RESOLVED, that in consideration of his agreement to provide consulting services to the Corporation, all stock options heretofore granted to Phillip C. Watkins, M.D. shall not terminate by reason of his resignation as a Director of this Corporation, but shall continue until their normal expiration dates, subject to termination in accordance with other relevant provisions of the relevant Stock Option Agreements.

There being no further business to transact, the Meeting was adjourned.

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Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

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Richard M. Scrusby  
Chairman of the Board  
and Chief Executive Officer

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**HEALTHSOUTH Corporation**

**WAIVER OF NOTICE**

We, the undersigned, constituting all the members of the Board of Directors of HEALTHSOUTH Corporation, a Delaware corporation, do hereby waive notice of the time, place and purpose of the Meeting of the Board of Directors of HEALTHSOUTH Corporation to be held on February 7, 2003, at 12:30 p.m. C.S.T., and we consent to the transaction of such business as may properly become before said Meeting.

DATED the 7th day of February, 2003.

\_\_\_\_\_  
Richard M. Scrushy

\_\_\_\_\_  
Joel C. Gordon

\_\_\_\_\_  
C. Sage Givens

\_\_\_\_\_  
Larry D. Striplin, Jr.

\_\_\_\_\_  
Charles W. Newhall, III

\_\_\_\_\_  
William T. Owens

\_\_\_\_\_  
John S. Chamberlin

\_\_\_\_\_  
Jon F. Hanson

\_\_\_\_\_  
George H. Strong

\_\_\_\_\_  
Robert P. May

**(H) HEALTHSOUTH.**  
One HEALTHSOUTH Parkway  
Birmingham, AL 35243

**MEMORANDUM**

**TO:** Audit Committee Members  
**FROM:** George Strong  
**DATE:** November 20, 2002  
**SUBJECT:** Audit Committee Charter Draft

Tab 91

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Here is the most recent draft of the new audit committee charter.

Please let me have the benefit of your comments.

Thank you.

GHS/pgh

Enclosure (1)

cc: Bill Owens  
Tadd McVay  
Richard Scrushy  
Bob May  
Bill Horton  
Jim Lamphron

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GS 0002375

(subject, if applicable, to shareholder ratification), compensation, and oversight of the work of the independent auditors, including resolution of disagreements between management and the auditor regarding financial reporting. The committee shall pre-approve all audit and non-audit services provided by the independent auditors and shall not engage the independent auditors to perform the specific non-audit services proscribed by law or regulation. The committee may delegate pre-approval authority to a member of the audit committee. The decisions of any audit committee member to whom pre-approval authority is delegated must be presented to the full audit committee at its next scheduled meeting.

At least annually, the committee shall obtain and review a report by the independent auditors describing:

- The firm's internal quality control procedures.
- Any material issues raised by the most recent internal quality control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues.
- All relationships between the independent auditor and the Company (to assess the auditor's independence).

In addition, the committee shall set clear hiring policies for employees or former employees of the independent auditors that meet the SEC regulations and stock exchange listing standards. The committee shall discuss with the internal auditors and the independent auditors the overall scope and plans for their respective audits, including the adequacy of staffing and compensation. Also, the committee shall discuss with management, the internal auditors, and the independent auditors the adequacy and effectiveness of the accounting and financial controls, including the Company's policies and procedures to assess, monitor, and manage business risk, and legal and ethical compliance programs (e.g., Company's Code of Conduct).

The committee shall meet separately and periodically with management, the internal auditors, and the independent auditors to discuss issues and concerns warranting committee attention. The committee shall provide sufficient opportunity for the internal auditors and the independent auditors to meet privately with the members of the committee. The committee shall review with the independent auditor any audit problems or difficulties and management's response.

The committee shall receive regular reports from the independent auditor on the critical policies and practices of the Company, and all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management.

The committee shall review management's assertion on its assessment of the effectiveness of internal controls as of the end of the most recent fiscal year and the independent auditors' report on management's assertion.

The committee shall review and discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

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CS 0002377



**ACACIA**

**VENTURE PARTNERS**

101 California Street, Suite 3160 • San Francisco, California 94111  
Telephone: 415-433-4200 • Facsimile: 415-433-4250

**MEMORANDUM**

**TO:** George Strong  
**FROM:** Sage Givens  
**RE:** Reaction to Audit Committee Charter  
**DATE:** December 5, 2002

1. I like the fact that it is relatively generic and broad. This leaves us greater flexibility.
2. The definition of "financial expert" as defined by the SEC seems very tough. Perhaps we should define it ourselves so as not to lock us in in the future.
3. Is Larry still considered independent? I do not know his financial background, but is he financially "literate"? I just don't know the answer here.
4. There is no mention of the Audit Committee's responsibility to communicate with the Board at large. I think we should have a vehicle for doing this regularly, without management.
5. The focus is mostly on the analysis of numbers, but not the meaning behind the numbers. Perhaps not in this memo, but somewhere, I think we need to understand the metrics behind the numbers, the "quality" of the numbers (especially earnings), and the strategic plan which the numbers reflect. I often think that we are looking at these numbers in a vacuum or just vs. Street estimates and would like to have a broader context.
6. There is no mention of company risk assessment as it relates to numbers. I think we must know what risks are inherent in the business environment to challenge the numbers on a going-forward basis—again a context for the numerical analysis.

GIVE LANGUAGE

\*

P3  
H3  
HORTON  
EDIT.

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CS 0002373

7. I am not regularly sent the 10Qs. Are you? I think we should regularly review the drafts and do more than rubber stamp the earnings vs. Street estimates a few hours before they are released.
8. For compliance purposes, should the audit committee members (or you as the chair) have an email or voicemail on the HRC system so that we can be contacted directly, if necessary by concerned employees?

Many of these observations need not be incorporated into the Charter, but they are on my mind as things we should agree or not agree about their relevance to our purview as members.

Hope this is helpful

Sage

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The committee shall review the interim financial statements and disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations with management and the independent auditors prior to the filing of the Company's Quarterly Report on Form 10-Q. Also, the committee shall discuss the results of the quarterly review and any other matters required to be communicated to the committee by the independent auditors under generally accepted auditing standards.

The committee shall review with management and the independent auditors the financial statements and disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations to be included in the Company's Annual Report on Form 10-K (or the annual report to shareholders if distributed prior to the filing of Form 10-K), including their judgment about the quality, not just the acceptability, of accounting principles, the reasonableness of significant judgments, and the clarity of the disclosures in the financial statements. Also, the committee shall discuss the results of the annual audit and any other matters required to be communicated to the committee by the independent auditors under generally accepted auditing standards.

The committee shall establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

The committee shall receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty.

The committee also prepares its report to be included in the Company's annual proxy statement, as required by SEC regulations.

The committee shall perform an evaluation of its performance at least annually to determine whether it is functioning effectively.

*Scope of Responsibility*

The audit committee is responsible for the duties set forth in this charter but is not responsible for either the preparation of the financial statements or the auditing of the financial statements. Management has the responsibility for preparing the financial statements and implementing internal controls, and the independent auditors have the responsibility for auditing the financial statements and monitoring the effectiveness of the internal controls. The review of the financial statements by the audit committee is not of the same quality as the audit performed by the independent auditors.

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CS 0002378

E&Y / HRC  
Fee Information

Draft: May 16, 2003

Tab 92

	notes	1998	1999	2000	2001	2002
Audit Fees		1,823,113	1,520,415	1,759,453	1,867,702	2,323,625
Audit Related Fees	(a)	2,329,809	2,005,042	1,913,429	1,684,724	2,733,586
Tax Fees		516,280	138,404	66,107	121,580	163,611
Consulting and Other Fees	(b)	-	-	-	-	-
<b>Total Fees</b>		4,669,202	3,663,861	3,738,989	3,674,006	5,220,822

(a) Audit Related Fees includes Pristine Audit fees in the following amounts: 1998: \$1,488,194; 1999: \$1,250,000; 2000: \$1,250,000; 2001: \$1,332,261; 2002: \$1,401,400.  
 (b) E&Y sold its management consulting practice in 2000.

1) THANK BILL OWENS + TAD MCVAJ + ERY  
(H) BILL HORTON

**HEALTHSOUTH**

WITH ERY + FIN STAFF PRESENT TO ANSWER QUESTIONS

SUMMARY OF LAST YEAR'S AUDIT COM. ACTIVITY

4 OF 8 MEETINGS GIVEN MOSTLY TO EXAMINING "POST ENRAN HOT BUTTONS" IS MEAS

BEGAN WHEN RAS ASKED FOR REVIEW OF OFF BAL SHEET ITEMS, IN 2002.

IF RESULT: RETURNED \$200M<sup>2</sup> IN SYNTHETIC LENSES TO B.S. IMP OF 02

A) OTHER OFF BALANCE SHEET ITEMS <sup>MA PRACTICE WORKERS COMP</sup> SPEC<sup>OS</sup> ONLY - 1) CAPTIVE INS. CO. \$106M<sup>1</sup> CASH \$22M<sup>2</sup>

2) REITS 70 PROPERTIES OUT OF 1600 \$57 MILLION ON BOOKS

B) PENSION LIABILITY - NO DEFINED BENEFIT PLAN

Tab 93

1) ~~401K~~ - TOTAL ASSETS \$300M<sup>2</sup> INITIATED 1/1/90 12,500 PART. NO HRC STOCK

10 T. ROWE PRICE FDS

2) ESOP NON CONTRIBUTARY 28,300 PART. 2,800,640 SHS ALLOCATED

3) STOCK PURCHASE PLAN 6,421 PART. 2,850,000 SHS IN A/C'S PAYROLL DEDUCTION CO MATCH 20% OF 1ST 200

4) EXECUTIVE RETIREMENT - OWENS FUTURE'S PLAN

(2)

(4)

**HEALTHSOUTH**

C) FIN 44 - JIM LAMPHRON EXPLAIN

D) STOCK REPURCHASE

9/30/98 AUTH 1.6M<sup>2</sup> SHS  
 BOT 1.5M<sup>2</sup> SHS @ \$12.04 = \$18.5M<sup>2</sup>  
 2/8/99 AUTH \$1B OVER 36 MOS.  
 '99 BOT 43M<sup>2</sup> SHS @ \$6.82 = \$29.5M<sup>2</sup>  
 '2000 BOT 400K SHS @ \$5 = \$2M<sup>2</sup>  
 2002 BOT 3.9M<sup>2</sup> SHS @ \$8.43 = \$33.3M<sup>2</sup>

TOT. 47.4M<sup>2</sup> @ \$6.78 = \$330.7M<sup>2</sup>  
 #700M<sup>2</sup> OF AUTH REMAIN  
 BANK COV. LIMIT TO 19M<sup>2</sup>  
 NO CURRENT ACTIVITY

E) DEBT REPURCHASE

AS OF 12/31/02 \$444.6M<sup>2</sup> @ \$93.3 =

F) OFFICER LOANS

25 LOANS = \$7M<sup>2</sup> LOAN PLAN DISCONTINUED

G) D+O COVERAGE

	PREMIUM
FORMER \$100M <sup>2</sup>	\$16M <sup>2</sup>
200M <sup>2</sup>	5M <sup>2</sup>

H) EMPLOYEE COMPLAINT TO AUDIT COM.

EMPLOYEE NAME CARD / BRAD FIELDS CALLS - REFERS TO AUDIT COM.

(3)

(4)

**HEALTHSOUTH®**I) TRANSMITTAL 1753

<sup>\$175MM</sup> IS A MOVING #  
VARIES WITH VOLUME + MIX

J) RELATED PARTY TRANSACTIONS1) RESOLVING CONFLICTS

- a) SHS SOLD MCD SHS TO HRC. <sup>\$1</sup> ~~FIN~~ ~~IT~~  
SHS TOLL AGREEMENT - DAPP FROM SEC INSDR
- b) SAGE - HICKS EXPLORING SALE  
OF ~~SHS~~ <sup>INTEREST</sup> IN L.P.
- c) NEWHALL - MCD WRITTEN TO ON  
BOTH BOOKS  
WORKING ON NEWHALL - <sup>\$477K</sup> MONTAGUE
- d) RMS + W.D. HAVE DONATED ~~SHS~~ <sup>SOURCE</sup>  
SHS TO CHARITY + SOLD MCD TO HRC
- e) L. STRAPLIN - GLASS CONTRACT -  
COMPETITIVE BID WITH GENL. CONT.
- f) J. GORDON - CONSULTING AGREEMENT  
RENEWAL OF CONTRACT FOR SALE OF  
SURE. Co. TO HRC.

K) INVESTMENT PORTFOLIO

17 INVESTMENTS ~~MARKET~~ VALUE ca \$42MM  
PAST 3 YRS <sup>\$35MM</sup> LIQUIDATIONS - <sup>\$11MM</sup> NEW INVESTMENTS  
BOOK VALUE = <sup>\$25MM</sup> - MKT = \$42MM EXCL. MCD + SOURCE

4

(H)

HEALTHSOUTH®

1) SOURCE & M.C.D

IN BUSINESS 2 YRS

1) SOURCE MEDICAL - AUTOMATION OF INFORMATION SYSTEMS  
 OUTPATIENT, ~~SEMI-OUTPATIENT~~ - REHAB & SURG. DIAG.  
 400 EMPLOYEES OFFICES & SURG. HOSPITALS  
 3500 INSTALLATIONS & CUSTOMERS 35% HRC +  
 HCA, TENET, SELECT  
 50,000 PATIENTS/DAY  
 30% OWNED BY HRC  
 ✓ success? 24% HRC MGMT  
 15% SOURCE MGMT  
 BAL 47 INDIVIDUALS FROM 3 ACQUISITIONS

REV RUN RATE \$40M<sup>2</sup>  
 EBITDA (\$13M<sup>2</sup>) POSSIBLE BREAK EVEN '03  
 HRC INVESTMENT \$97M<sup>2</sup>

BILL OWENS HAS DEVELOPED CONTINGENCY & MONITORING PLAN

2) MED DIR DIRECT - AUTOMATED GROUP PURCHASING

100% OWNED BY HRC  
 0 COST BASIS  
 \$30M<sup>2</sup> LOAN 6TY  
 GROUP SELL BY JUNE

CONFIDENTIAL TREATMENT REQUESTED

GS 0001626

12) EXERCISE STOCK OPTIONS - STOCK PURCHASE FEATURES

1) reviewed numbers  
 auditors reviewed audit "looked up  
 little sample" - substantially done - looks  
 good  
 Special Purpose entities -> Barndays  
 3 synthetic lease \$187m<sup>2</sup>

2) HEC equity investments - HEC + Officers  
 & Directors source 40-45% 350K  
 budget 1990 0

3) REIT'S (8 facilities) \$80m<sup>2</sup> +

4) 401K'S NO HEC Tab 94

5) A/R'S & def inv. - contractual  
\$5m<sup>2</sup>

6) Non-mapping items - (subshew)  
 - interfied with  
 disclosure - future emphasize GAAP.  
 (also emphasize GAAP)

Changes coming - SEC & audit Bd. (

consolidation, training,

consolidation, dmy -> subshew  
height  
cur.



HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
OCTOBER 29, 2002  
MINUTES                      Tab 96

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 29, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Larry D. Striplin, Jr., Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, and Lanny J. Davis of Patton Boggs, LLP. With the exception of Mr. Strong, who participated via a telephonic connection whereby everyone could freely hear and speak to one another, all Directors and guests were physically present with Mr. Scrusby in the Board Room.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 8:00 a.m. C.S.T.

**Executive Session**

The Meeting began in executive session with Messrs. May and Hanson presenting to the Board all documents provided by the law firm of Fulbright & Jaworski, L.L.P. in connection with its investigation of management's knowledge of CMS Transmittal 1753.

The Board reviewed Fulbright & Jaworski's supplemental letter clearing Mr. Scrusby of all allegations of insider knowledge concerning the impact of a Medicare reimbursement rule change

*DD met with RS of all knowledge*

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TREATMENT REQUESTED

JG 0000479

prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 30, 2002.

*As Challenges  
Findings refer  
on shoulders of  
other than  
Long Dan  
to not ask  
had them to  
word on  
Monday*

The Board also agreed to hold a Board Meeting on November 13, 2002, to review final recommendations from Messrs. May and Hanson, if any, regarding members of management's knowledge and understanding of CMS rule changes.

In association with these matters, the Board requested a review to be conducted by a qualified outside party (law professor, retired SEC attorney, etc.) of the Corporation's Legal Services Department, its systems and qualifications of staff, including its Corporate Counsel. Upon conclusion of the review, a summary of findings and recommendations are to be made to the Chairman and the Board of Directors. The Board also directed that the Corporate Counsel should report directly to the Chairman of the Board.

**Compensation Committee Action**

Mr. Scrushy advised the Board that the approval of the Compensation Committee's recommendation of bonuses to be awarded to the Corporation's executive officers had been omitted from the May 16, 2002 Minutes. Mr. Scrushy asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 Minutes amended to reflect this action.

*This was a  
not for  
offer*

After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Striplin, the following resolution was unanimously adopted:

RESOLVED, that the Board of Directors hereby ratifies and confirms, as of May 16, 2002, the bonus recommendations made by the Compensation Committee at the May 16, 2002 Board Meeting and the payment of such bonuses in accordance with such recommendations, and further directs that the minutes of the May 16, 2002 Meeting of the Board of Directors be amended to reflect such approval.

In other Compensation Committee business, Mr. May resigned from the Committee and Mr. Chamberlin was asked to serve as Chairman. After discussion, upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the Board of Directors hereby accepts the resignation of Robert P. May from the Compensation Committee and thanks him for his service thereon.

RESOLVED, that John S. Chamberlin is hereby appointed as Chairman of the Compensation Committee, to serve until the next Annual Meeting of the Board of Directors and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal.

**Compliance Committee Action**

The Board discussed Mr. Gordon's ineligibility to serve on the Compliance Committee because of his status as an employed consultant of the Corporation. As a result, Mr. Gordon resigned from the Committee, and Mr. Scruschy requested that Ms. Givens serve on the Committee in place of Mr. Gordon, and that Dr. Watkins serve as its Chairman. After discussion, upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the Board of Directors hereby accepts Joel C. Gordon's resignation from the Compliance Committee and thanks him for his service thereon.

RESOLVED, that C. Sage Givens is hereby appointed to the Compliance Committee, to serve until the next Annual Meeting of the Board of Directors of this Corporation and until her successor is duly appointed and qualified, or until her earlier death, resignation or removal.

RESOLVED, that Phillip C. Watkins, M.D. is hereby appointed as Chairman of the Compliance Committee, to serve until the next Annual Meeting of the Board of Directors and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal.

**Other Business**

Mr. May distributed to the Board members drafts of charters for the Corporate Governance Committee, Audit Committee, and Compensation Committee, and a draft of an Insider Trading Policy. Mr. May requested that the Board members review each document and return comments to him prior to the next Board Meeting.

*Mr. Gordon did not resign at the meeting, but request to resign and respond in minutes*

*Approved acceptance resignation not record at the time*

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrusby  
Chairman of the Board



Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

(1)

HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS

JULY 11, 2002

MINUTES

Tab 97

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated July 11, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation, Phillip C. Watkins, M. D., C. Sage Givens, Charles W. Newhall III, John S. Chamberlin, Joel C. Gordon, Larry D. Striplin, Jr. The following guests were also present: Brandon O. Hale, Executive Vice President - Administration and Secretary, and Malcolm E. McVay, Executive Vice President - Finance and Treasurer of the Corporation. Joining Mr. Scrusby in the Corporation's Board Room were Messrs. Hale and McVay. The other members participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 11:25 a.m. C.D.T.

The purpose of the Meeting was to update the Board on the sharp decline in the Company's stock price as a result of rumors in the investment community. Mr. Scrusby advised the Board that there was no substance to the rumors and no known reason other than the rumors for the decline in the stock price. He also advised the Board that the Company was preparing a press release stating that the Company was comfortable with the consensus earnings estimates for the second quarter. Mr. Scrusby stated that second quarter earnings would be released on August 7 and were expected to show strong operating results for the quarter.

*Comfortable with estimates on July 11, on Aug 7, saying release was not good*

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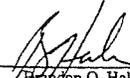
JG 0000454

There being no further business to transact, the Meeting was adjourned.



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Richard M. Scrusby  
Chairman of the Board  
and Chief Executive Officer



---

Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

III

Tab 98

### Audit Committee Agenda

Wednesday - November 13, 2002

MINUTES IN  
1WK

I. Review Annual Audit Plans with E&Y

MORE COMPLEX  
WIDE TIME  
CASH FEE - 1WK

II. Necessary Changes for Compliance with

REVIEW SOURCE MEDICAL  
CIRCULATE PACK  
MED CENTER DIRECT  
OTHER ASSETS  
(VILLIERS)

a. Sarbanes - Oxley Act

b. NYSE Requirements

Necessary Charter Revisions?

III. Other Issues POST ENRON HOT BUTTONS

a. Off-Balance Sheet Update (SPE's)

b. Sale/Leaseback Summary (REIT's)

c. 401-K Summary

d. ESOP Summary

e. Employee Stock Purchase Plan Summary

f. FIN 44 Update (OPTIONS) 1.5M 2.5M 11/13 5-6 YRS TO GO

g. Stock Repurchase Update

h. Debt Repurchase Update

i. Officer and Non-Officer Loans NO MORE #1, #2 OTHER

j. D&O Coverage

k. System for Employees to ask questions and voice complaints

l. Transmittal 1753 and \$175MM estimate ADDITIONAL GOODS WILL WRITE OFF

IV. Other Q&A as Time Permits

SEE DRAFT II

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TREATMENT REQUESTED

V. Internal Audit Report (Excludes Management) <sup>CHAFFER BUDGET</sup>  
~~PLANS '03~~

VI. Outside Audit Report-E&Y (Excludes Management) <sup>CRAMPED FOR</sup>  
~~WORK CHAFFER - EXPANDING TIME ON ST. CLOSE~~  
<sup>REVIEW MORE DEMANDING</sup>

Attendees: George Strong, Sage Givens, Larry Striplin, Tadd McVay,  
Bill Horton, Brad Hale, Jim Lamphron, Wayne Dunn, Emery Harris,  
Jason Brown and Greg Smith

MEET w/12

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GS 0002537

Investment Adjustments

Tab 99

Source Medical

Investment (approximate)	400,000		
Advances (approximate)	95,000,000		
Total Investment	95,400,000		
	2001	2002 (estimate)	Total Loss to record in 2002
Net Loss	(1,985,381)	(20,000,000)	18,014,619
Ownership percentage	35%	35%	- 29.39% Convert %
HRC loss	(695,053)	(7,000,000)	(7,695,053)

MCD

Investment	2,210,000 (written off by HRC in 2001)		
Guarantee	15,000,000 Entered into in 2001		
Additional Guarantee	5,000,000 Entered into in 2002		
Advances	10,000,000 Entered into in 2002		
	2000	2001	2002 (estimate)
Net Loss	(20,208,112)	(16,570,369)	(20,000,000)
Ownership percentage	27.31%	27.31%	27.31%
HRC Loss	(5,600,765)	(4,575,504)	(5,462,000)
Loss Recognized	2,210,000	2,210,000	2,210,000
	(5,600,765)	(2,315,504)	(5,462,000)

Other Investments (as of 9/30)

	Book	Fair Value	
Acacia	2,643,832	703,202	Key and Will are in process of reconciling
Bridge Medical	1,193,303	1,180,901	
Fitlinx	1,000,000	-	
Latin Healthcare Fund	1,956,673	1,385,447	
Lifematrix	1,312,392	382,408	
Montague Newhall	1,518,284	972,225	
OrthoRx	4,165,000	2,575,414	Equity Method (40.5% of \$3.9 million loss)
Stonebridge Technologies	3,000,000	-	being reviewed - should this be PPE or investment
	16,792,384	7,199,597	(9,592,787)

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W:77 - call Sage & Chuck about selling Acacia investment



Wayne W. Dunn Jr  
02/22/2003 03:46 PM

To: Susan.Smith@Healthsouth.com  
cc: Bill.Owens@Healthsouth.com, James P. Lamphron/Southeast/AUDIT/EYLLP/US@EY-NAmerica, Curtis W. Miller/Southeast/AUDIT/EYLLP/US  
Subject: Information Needed 

**Tab 100**

Susan,

As we are reviewing the information provided, we need to get some additional information as soon as possible. I'll touch base with you 1st thing Monday morning to get this information.

1. What is the process performed on a quarterly basis to review the allowances. Provide details of who does what and when it is done - at a facility basis, in operations and by your group. Also, are there guidelines that are followed for booking the allowances (both contractual and bad debt) at the facilities or by accounting, for determining when accounts are written off, etc. If so, what are the guidelines and have they changed from 2001 to 2002?

2. What has been the impact of transmittal 1753 on reimbursement. Can you provide support for me as follows for a facility (be very specific - at a patient level):

Prior to 1753 - Individual therapy rates vs. reimbursement  
Group therapy rates vs. reimbursement

Post 1753 - Individual therapy rates vs. reimbursement  
Group therapy rates vs reimbursement

If necessary, show this for the different payors - Bill indicated to us that reimbursement as a percent of charges had declined overall in the O/P division.

3. At what point did the company go back and revise billings for the impact of transmittal 1753. Was this done before the third quarter was complete? Was it in process at the end of the third quarter? Did the third quarter final numbers reflect this change in its entirety or was there any impact in the fourth quarter as a result of possibly catching up the third quarter?

4. Provide support that PPS improves reimbursement percentage - show that HRC was paid more under PPS as a percent of charges than was being paid previously. I need to be able to test this information by tying back to detail support. What I would like is for you to choose the 10 facilities with the largest revenue and provide the total reimbursement as a percent of charges from the as-filed 12/31/01 cost reports and compare that to a 9/30/02 PS&R report that shows payments as a percent of charges.

5. I need collections by division for '01 vs '02 (by quarter if available) in a format that I will be able to tie back to detail supporting information (I mentioned this to Bill so you may want to make sure he isn't getting someone else to do this).

6. I need the schedule of A/R days by division - I did not get a copy of the one we looked at yesterday.

7. I need the schedule that you had that showed A/R and allowances by division (it was a comparison report you and Bill were looking at - it was not in the documents you gave me yesterday)

8. I need the following information to support the Allowance calculations (these items were in the original client assistance list):

- \* Bad debt grid information - including aging data - in electronic format
- \* Medical Centers - 687 reports for Doctors, Dallas and Birmingham

EYDF 003585  
CONFIDENTIAL

- \* I/P - 687 reports for the 40 facilities with the highest A/R balance - summarize the payments and adjustments by facility between Medicare and Non Medicare, consistent with prior year
  - \* O/P - Provide the zero balance report for the division detailing amounts by Medicare, non medicare and capitation - separate charges, payments and adjustments. Exclude any amounts from Co. 50 facilities  
Provide a copy of the detail zero balance report by patient for the 10 largest facilities for us to test.
  - \* Surgery Center - Do any facilities still record A/R at net - if so, provide supporting documentation for the net value - provide the Insurance Analysis report for the top 10 facilities.  
Provide a copy of the zero balance report for the division detailing amounts - separate charges, payments and adjustments.  
Provide a copy of the detail zero balance report by patient for the 10 largest facilities for us to test.
  - \* Diagnostic - Provide a copy of the zero balance report for the division detailing amounts - separate charges, payments and adjustments.  
Provide a copy of the detail zero balance report by patient for the 10 largest facilities for us to test.
9. Provide support for retro change of \$50 million - what does it relate to - provide a detail of the \$50 million. What caused the changes on the home office - when was it filed, why is this a 4th quarter issue?
10. I am still going through things so I will let you know if there are other things I need.

Thanks,  
Wayne  
969-7591

EYDF 003586  
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Tab	Document Description	Date	Bate #
<b>Howard Capek Documents</b>			
1	Warburg Dillon Read Doc. To L. Murphy, From H.Capek Re: Here it is!	6/4/1999	42-2446
2	BOD Mtg Minutes	6/14/1999	18-02103
3	Capek email to Susan Zeeb Re: HRC	8/19/1999	66102
4	Capek email to Susan Zeeb Re: HRC	9/10/1999	66101
5	Dalton email to Capek Re: HealthSouth	9/27/1999	66172
6	Capek email to Dan Martin	10/25/2001	35033
7	Capek email to Rich Schneider Re: HRC	9/27/2002	37618
8	Capek email to Noble Re: He just doesn't get it	1/7/2003	38157
<b>Benjamin Lorello &amp; William McGahan Documents</b>			
9	UBS Warburg doc. Case Studies: Selected Long Term UBS Warburg Relationships	NA	148618
10	UBS Memo Re: HSC/MedCenterDirect Com, Inc	3/27/2001	102498
11	McGahan email to Lorello Re: establishes Lorello's involvement w/ HS	Oct-01	80964
12	McGahan email to Owens Re: Things to do at board meeting	10/13/2001	80939
13	Garson email to Kusmierz Re: Why is HRC selling assets below market or alternatively why is HCl setting rents so low.	12/19/2001	148244
14	Global New Client/Project Approval Form (McGahan)	12/26/2001	148584
15	Oneill email to McGahan Re: HealthSouth Reit	3/15/2002	90188
16	UBS Warburg Minutes of Leveraged Finance Commitments Cm'tee mtg	3/28/2002	112494
17	UBS Warburg Committee Minutes	5/6/2002	113054
18	UBS Warburg Minutes of Leveraged Finance Commitments Cm'tee mtg	5/8/2002	113095
19	UBS Warburg Committee Minutes (Capek on the line)	5/13/2002	113056
20	Oneill email to Owens et al Re: Preparation for Thursday Conf Call w/ Board	8/13/2002	70094
21	Oneill email to Peggy Fay Re: Draft Press Release	8/23/2002	179787
22	McGahan email to Horton Re: Surgery Center Transaction	9/18/2002	04100
23	Heather White email to Lorello and McGahan Re: Expense Reimbursements	11/27/2002	95595
24	UBS Warburg Minutes of GSF Commitments Cm'tee Mtg	12/23/2002	217718
25	UBS Credit Risk Control Re: Source Medical Solutions, Inc.	Fall 2002	163398
26	UBS Warburg GSF Commitment Cm'tee Mtg Re: Source Medical Solutions	2/26/2003	218410
27	McGahan memo Re: Amdt to HS's current \$1.25 billion Credit Facility...	3/4/2003	215815
28	"Minutes of the Leveraged Commitments Committee Meeting"	3/6/2003	113234
29	McGahan email to Oneill "I just got my ass whipped by Scrusy and Owens"	3/6/2003	155137
30	McGahan email to Oneill and Leder	3/6/2003	155305
31	McGahan email to Leder & Lorello Re: Scrusy fwd "I will put up the \$\$\$ myself"	3/6/2003	92905
32	McGahan email to Lorello Re: I hate my job. I resign.	3/6/2003	92904
33	Handwritten notes Re: HRC bank amendment	3/7/2003	65505
34	McGahan email to Leder Re: email from Scrusy	3/7/2003	155138
35	Oneill email to Leder Re: We don't have a balance sheet - move on	3/7/2003	155363
36	UBS Warburg Minutes of GSF Commitments Cm'tee Mtg	3/11/2003	154000
37	Memo from Corporate Finance Re: Amendment to HEALTHSOUTH's current \$1.25 billion Credit Facility	3/11/2003	112498

HealthSouth Document Binder #2  
Panel 4  
11/05/2003

38	Ryan email to Bawden Re: 'Scrusy only stands accused...'	3/19/2003	229818
39	UBS Warburg Doc Re: First Cambridge Transaction Overview	3/31/2003	148593
40	Transcript of tape recorded phone call btw Bill Owens and ??	5/15/2003	NA
<b>Lanny Davis &amp; Hal Hirsch Documents</b>			
41	Davis email to Hirsch Re: informing Hirsch he will represent the Audit Cm'tee	9/14/2002	11176
42	BOD Meeting Minutes	9/17/2002	18-02297
43	Hirsch email Re: w/ SEC inquiry open, need to move off chronology...	9/18/2002	11181
44	Davis email to Adam Goldberg challenging Martha Kendrick's distribution of an email from Davis	9/21/2002	2823
45	Davis email to Scrusy Re: Davis as counsel or co-counsel in all litigation.	9/22/2002	02309
46	Davis letter to Scrusy Re: Engagement of Patton Boggs LLP	9/23/2002	138
47	Neil Gold email to Hirsch Re: Allowing Davis to view "our work product".	10/1/2002	10495
48	Depke email to Unger & Hirsch Re: More shreds	10/1/2002	10496
49	BOD Meeting Minutes	10/1/2002	18-02306
50	Davis email to Hirsch Re: Personal (asking Hirsch to be his co-counsel on all HS matters)	10/2/2002	2036
51	Hervey email to Scrusy Re: Hals response on timetable for Report	10/7/2002	00061
52	Gordon Letter to Scrusy Re: Concerns from recent BOD meetings	10/8/2002	719
53	Davis email to Scrusy Re: F&J Final Report (Hirsch plans for completion on 10/18/02)	10/13/2002	8195
54	Kaplan email to Hirsch Re: Presenting Gordon's Ltr to the entire Board.	10/15/2002	10708
55	Davis Ltr to Gordon Re: Your letter of Oct. 8, 2002 to Richard Scrusy	10/15/2002	408-1411
56	BOD Meeting Minutes	10/15/2002	18-02310
57	Davis email to Hirsch Re: Denton meeting went very well!!!	10/17/2002	9864
58	Hirsch email to Horton Re: beginning review of draft Report	10/18/2002	00897
59	Marcia Newman email to Hirsch Re: Lanny Davis	10/18/2002	9384
60	Hirsch email to Davis Re: Telling Davis he see the Report in the morning.	10/19/2002	9897
61	Hirsch email to Davis Re: HS Report	10/19/2002	9903
62	Galant email to Hirsch Re: Re-interviewing Scrusy about July 8, 2002 MMM	10/19/2002	9911
63	Hirsch email to Horton Re: HS Fulbright Report (reviewing w/ Davis)	10/20/2002	10738
64	Hirsch email to Tom Dowdell Re: I am on with Lanny- all is well I need 15 minutes	10/20/2002	9429
65	Hirsch email Re: Document will be presented to the Board on Tuesday	10/21/2002	00134
66	Davis email to Hirsch Re: "If it is in final form..."	10/21/2002	9997
67	Hirsch forward to Scrusy Re: pre-knowledge of the Report	10/21/2002	00144
68	BOD Meeting Minutes (F&J)	10/22/2002	18-02313
69	BOD Meeting Minutes (Patton Boggs)	10/22/2002	247-1855
70	Dowdell email Hirsch et al Re: HS's Monday Morning Meetings (MMM)	10/23/2002	10758
71	Sjoquist email to Davis & Goldberg Re: Compliance Integrity Agreement	10/24/2002	2852
72	Davis email to Eileen O'Connor Re: Draft Release for Comments on Report	10/24/2002	1898
73	Carl Kaplan email to Hirsch Re: Lanny Davis	10/25/2002	10056
74	Hervey email to Scrusy & Davis Re: Pressuring Dick and Hal for Report	10/26/2002	00150
75	Davis email to Scrusy, Hervey, and Hanson "Hope you are all having a good..."	10/26/2002	1879
76	Hirsch email to Horton Re: Thanks for sending the draft press release	10/29/2002	10818
77	Hirsch email to Neil Gold Re: Comments on Draft Press Release	10/29/2002	10829
78	Hirsch email Re: Supplemental Letter	10/29/2002	10838
79	BOD Meeting Minutes	10/29/2002	552
80	BOD Meeting Minutes Handwritten	10/29/2002	293-0253

HealthSouth Document Binder #2  
 Panel 4  
 11/05/2003

81	HealthSouth Press Release Re: Scrushy cleared of advance knowledge of 1753	10/30/2002	NA
82	Neil Gold email to Hirsch Re: CORRECTED- UPDATE 1 Law firm cleared HS chair on share trades	10/31/2002	10879
83	Hirsch email to Horton et al Reuters article Re: Bold text of Davis quotes.	10/31/2002	10880
84	Neil Gold email to Hirsch Re: CNN clip on HealthSouth	10/31/2002	10882
85	Neil Gold email to Hirsch Re: HealthSouth	10/31/2002	10886
86	Davis email to Adam Goldberg Re: HealthSouth	10/31/2002	1852
87	Series of emails Re: how much of the Report will be released to the SEC	10/31/2002	10890
88	F&J memo to Hanson/May Re: Notice Regarding Doc Review (shred copies)	10/31/2002	3421
89	Unger email to Licon & Hirsch Re: Getting Hirsch copies of covers letters to the reports sent to the SEC.	11/1/2002	6366
90	Horton email to Scrushy Re: Lanny being Lanny	11/2/2002	00173
91	Hirsch draft letter to Scrushy Re: FTI Consulting	11/5/2002	262
92	Davis email to Hirsch Re: Response to demands for Mr. Unger's continued representation of the company before the SEC.	11/7/2002	1776
93	Scrushy email to Hervey Re: Hirsch's email venting to Scrushy	11/8/2002	67
94	Hirsch email to Debbie Smith Re: Scrushy's request to see report before payment of fees.	11/8/2002	3036
95	Smith email to Davis Re: FTI remaining fees owed \$116,576	11/12/2002	2379
96	BOD Meeting Minutes (Cease F&J matters)	11/13/2002	18-2320
97	BOD Meeting Minutes Handwritten	11/13/2002	293-0215
98	Davis email to DiNapoli at FTI Re: Forwarded invoices and narative	11/18/2002	1667
99	Horton email to Scrushy Re: Draft complaint challenging Transmittal 1753 as a "rule change" not a "clarification"	12/3/2002	371-0022
100	Davis email to Hervey, Scrushy... Re: NY Times Sat story.	1/27/2003	1615
101	Davis email to Robert May Re: Sad	2/10/2003	1618
102	Davis email to Goldberg Re: draft memeo re conflict issue	3/24/2003	2932
<b>Fulbright &amp; Jaworski Documents</b>			
103	Memo to David Barrack From Hirsch Re: HealthSouth	9/23/2002	510
104	Fulbright Letter to BOD Re: Investigation Update	10/1/2002	293-0300
105	Fulbright Letter to BOD Re: Investigation Update	10/21/2002	16/0111
106	Fulbright Letter to BOD Re: Conclusion of Investigation	10/29/2002	16/0128
107	Fulbright Letter to BOD Re: Destruction of documents at HealthSouth	10/29/2002	506
108	Martin Cohen letter to Bill Owens Re: F&J Report	11/6/2002	44-1119

JUN. 4. 1999 11:30AM

 Warburg Dillon Read

NO. 094 P. 1/5

Warburg Dillon Read LLC  
299 Park Avenue  
New York, NY 10171-0026  
Telephone 212 821-4000  
www.wdr.com

Tab 1

To: L. Murphy  
From: H. Capek  
5 pages total

Here it is!

Warburg Dillon Read LLC is a subsidiary of UBS AG.  
Warburg Dillon Read is the investment banking division of UBS AG.

Member SIPC  
Member New York Stock Exchange  
and other Principal Exchanges

HHEC 42-2446

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Requested by  
HealthSouth Corp.

## INTERNAL USE ONLY - DRAFT

Warburg Dillon Read LLC  
Howard G. Capik 212-421-4369June 4, 1999  
Austin H. Barkau 212-421-9452

## Healthsouth Corp. (HRC - NYSE) - Strong Buy

US Health Care									
Price:	14.44	Dividend:	Nil	Mkt Cap:	6.4b	Est Debt/TC:	43%		
Target:	22.00	Yield:	Nil	Strg O/S:	442m	ACR:	14%		
12 Wk R:	30.00 - 8.31	5yr EGR:	15 %	Avg Vol(000):	1879	Est Val:	8.1b		
				Est B Value:	8.15	CV Sec:	No		
Fiscal Year Quarterly Estimates - EPS					Fiscal Year Estimates - EPS				
	1Q	2Q	3Q	4Q	Price	EPS	P/E	Rev(m)	
1998:	0.26 A	0.38 A	0.28 A	0.27 A	Dec/ 1998 A:	1.09	13.2	5963	
1999:	0.26 A	0.27 E			Dec/ 1999 E:	1.11	13.0	4289	
2000:					Dec/ 2000 E:	1.30	11.1	4660	

## REITERATING STRONG BUY, DISPELLING SOME NEAR-TERM MARKET CONCERNS

## Summary:

We wish to focus investor attention on HRC's operating trends, underscore our investment thesis, and dispel a bit of what we perceive to be market misperception. Operating results continue to trend favorably, and we remain focused on the sequential earnings progression and momentum in 2H99 and into 2000. Our concerns with respect to government reimbursement issues are minimal; this view is based on HRC's non-government reimbursed business development and comprehensive asset base, as well as on the company's low cost structure and specific type of Medicare business in which it participates. Early results in 2H99 should provide the catalyst for meaningful stock price appreciation. We believe investors should aggressively build positions now. Our 12-month price objective is \$20.

## Highlights:

- HRC is one of the best positioned health care service providers, with a unique asset concentration and business model focused on rehabilitation and outpatient services. Given minor business mix issues and broader health care operating volatility and reimbursement concerns, we believe investors have overlooked HRC's market positioning, operating strength, and cash flow generation potential.
- We focus investor attention on 2H99 and early 2000 earnings results. We believe this EPS progression and potential for upside momentum should be both the catalyst for stock price performance and the evidence needed to allay investors' near-term business concerns.
- We recommend aggressive purchase of the shares of HRC today, based on the company's cash flow generation, solid business model, and relatively strong organic growth trends.
- HRC is Over Its Invested Capital "Bubble". In 1997 and 1998 HRC completed a significant number of acquisitions, adding about \$3.6 billion to its invested capital base. With this activity behind it, we expect HRC to harvest cash flow generated from better asset turnover (throughput or utilization) and operating margin improvement that should result from integration and internal development.
- Investor Expectations for Growth are Muted. Current valuation should provide investors with

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limited downside exposure. In fact, after discounting our 1999 proxy for after tax cash flow at HRC's weighted average cost of capital (WACC), which assumes a zero growth state in perpetuity, we arrive at roughly 65% of current equity value. In other words, only 35% of today's share price reflects the present value of future growth opportunity. This should allow for upside stock price potential based solely on HRC's ability to meet current earnings expectations. Our \$20 price objective would imply a present value of future growth opportunity equal to 56% of the stock price; still a conservative scenario.

**Analysis:**

**INVESTMENT THESIS:**

Our investment thesis on HRC centers on strong organic growth, supported by service breadth, a sound cost structure, proven operating and acquisition track record, and strong cash flow and balance sheet. HRC's asset base has taken nearly 10 years to develop through solid organic growth and strategic acquisition. Based on availability of assets and access to capital, this base is neither quickly or easily duplicable. In our view, HRC owns the model in rehabilitation and outpatient services. Despite conservative expectations of essentially flat year-over-year earnings growth, we focus on the sequential earnings ramp-up and the potential for better than expected results in 2H99. HEALTHSOUTH scores well across our investment mantra, possessing (1) organic growth, (2) balance sheet integrity, (3) franchise value, and (4) a viable business model.

Although HRC's near-term pricing and business mix issues (along with broader health care sector jitters) could continue to fuel near-term trading volatility, we recommend purchase of HRC's shares for investors with time horizons of greater than six months. In addition, we highlight the following points in support of our investment argument:

**Powerful cash flow and organic growth engine.** HRC has been in acquisition mode for the past few years. Given its market position and ability to deliver 8-10% organic top-line growth, we expect HRC to harvest cash, prudently allocate capital (including share buy-backs), and deliver 15% annual EPS growth. For 1999, we expect HRC to generate \$0.58 per share (\$250 million) in free cash. This roughly a 4% cash yield.

**HRC is Over Its Invested Capital "Bubble".** In 1997 and 1998 HRC completed a significant number of acquisitions, adding about \$3.6 billion to its invested capital base. With this activity behind it, we expect HRC to harvest cash flow generated from better asset turnover (throughput or utilization) and operating margin improvement that should result from integration and internal development.

**HRC Owns A Leadership Position in an Attractive Niche Sector.** The rehabilitation and outpatient delivery market continues to grow at an 8-10% annual rate. The roughly \$24 billion rehab sector should continue to benefit from the three macro drivers of healthcare; cost-containment, demographics, and technology advances. We estimate HRC serves about 20% of this fragmented localized market.

**Investor Expectations for Growth are Muted.** Discounting our 1999 proxy for after tax cash generation at HRC's weighted average cost of capital (WACC), which assumes a zero growth state in perpetuity, we arrive at roughly 65% of current equity value. In short, only 35% of today's share price reflects the present value of future growth. This provides for limited downside and more important, upside stock price potential based solely on HRC's ability to meet current earnings expectations. Historically, this present value of future growth opportunity represented between 50% and 80% of common share price. Please note that our \$20 price objective would imply a present value of future growth opportunity equal to 56% of the stock price.

<http://imagine.ny.ubs.co.../GetNote?noteid=5525&database=0&b=note&body=true&single=true> 6/4/99

**Investment Concerns**

In our view, investor sentiment is currently being driven by two types of concerns, company-specific and industry-related. Company-specific concerns center around managed care pricing trends (mainly in HRC's outpatient business), while sector concerns center on government reimbursement and investigatory environments. In addition to arguing that these concerns are somewhat overblown, we also believe that current equity valuation reflects these issues.

HRC's pricing trends. One of the main drivers of lowered EPS expectations for 2H98 and 1999 was a downward pricing trend in HRC's rehabilitation segments. This price pressure also encompassed lowered unit growth expectations as HRC chose not to pursue irrationally priced business. Based on the improvement in the managed care business and pricing cycle, as well as on HRC's dominant asset base, we expect 1998's pricing trends to be short-term, with price stability (and perhaps some of the business lost from attrition) returning in late 1999 and 2000. This, combined with a favorable 2H99 earnings progression should provide the catalyst for stock price performance.

Perceived Medicare reimbursement risk HRC is neither a hospital nor a long term care provider. Still, it is often categorized as either when it comes to Medicare reimbursement worries. HRC continues to grow its non-government business and maintain an operating cost structure that should enable it to weather (limit its exposure to) any Medicare reimbursement changes. HRC is not directly exposed to long term care prospective payment (PPS). For hospital-based outpatient PPS (expected for April 2000 at the earliest), HRC's exposure should be limited to its four acute care hospitals and its outpatient rehab and surgery business. We note that HRC's outpatient rehab and surgery business derives about 10% of net revenue from Medicare and these businesses are already essentially operating under fee screens, which eliminates HRC's exposure to any potential changes in co-payment levels. In short, relative to hospital and other providers, HRC should well-manage through outpatient PPS. Moreover, given current share price levels and investor expectations, the worst-case operating scenario is somewhat well reflected.

Finally, in response to questions in the marketplace, we as a research team would like to clarify our position on HRC stock. There seems to be some confusion regarding Geoff Harris' current opinion on HRC, relative to his published research opinion at his former employer and the Warburg Dillon Read LLC (WDR) current research opinion. To clarify, HEALTHSOUTH was Mr. Harris' "Stock Pick of the Year" on numerous occasions while at his former employer, and also one of the relatively better operating companies and stock performers under his coverage from 1993 to 1998. The company's strategy of providing high quality, low-cost, comprehensive rehabilitation and outpatient services on a national scale well position it with managed care, physicians and patients in one of the most consumer-driven segments of health care. This market position is highly defensible and difficult to duplicate, and sets HRC apart from most other health care providers.

Mr. Harris, while at his former employer, published a research opinion on HRC from 1988 through 1998. In the fall of 1998, Mr. Harris lowered his earnings forecast for HEALTHSOUTH. Important, Mr. Harris never lowered his rating on HRC, maintaining a Strong Buy, reflecting the company's asset base and cash flow. In retrospect, Mr. Harris' handling of the lowering of his estimates was not well executed, perhaps creating confusion in the marketplace and catching the company off guard. For this disruption and miscommunication, Mr. Harris has apologized.

Mr. Harris' current view of HEALTHSOUTH concurs with our current Strong Buy rating. Since starting employment with Warburg Dillon Read, Mr. Harris, in addition to assuming the role of global head of health care research, has narrowed his coverage to the managed care universe, and no

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longer covers health care service providers. Howard Capek, upon starting employment at WDR in May, covers the specialty and non-hospital health care service providers, which includes outpatient and rehabilitation service providers. Mr. Capek reinstated coverage on HEALTHSOUTH with a Strong Buy on May 18, 1999, and the entire research team supports his recommendation. Please see our 18-page research report dated May 18, 1999 for company details and Mr. Capek's current outlook for the company. All questions regarding HEALTHSOUTH should be addressed to Mr. Capek, who has been covering HEALTHSOUTH since 1994.

**VALUATION:**

HRC's shares are trading at 13 times our 1999 EPS estimate and 6.4 times 1999 EV/EBITDA forecast. We believe the shares are significantly undervalued, relative to the stated earnings growth rate of 15% and HRC's market position. Time and a re-establishment of an operating track record should allow a more fundamental valuation to develop, giving us a 6-to-12-month price objective of \$20. Our price objective reflects a 1999 EV/EBITDA multiple of 8.5x, a conservative valuation given HRC's relative positioning to more traditional health care providers (hospitals) and its ability to generate cash and organic growth. Based on our 1999 forecast, we expect HRC to generate about \$250 million in free cash (after cap-ex, working capital, and build-out cap-ex) prior to share repurchases. This is about \$0.57 per share in cash, or a cash yield of about 4% based on current share price.

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First Call

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MEETING OF THE BOARD OF DIRECTORS

JUNE 14, 1999

Tab 2

## MINUTES

A Meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room of the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated June 14, 1999, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of the Corporation. James P. Bennett, President and Chief Operating Officer of the Corporation. Anthony J. Tanner, Executive Vice President and Secretary of the Corporation, Michael D. Martin, Executive Vice President, Chief Financial Officer and Treasurer of the Corporation, P. Daryl Brown, President and Chief Operating Officer — HEALTHSOUTH Outpatient Centers, Charles W. Newhall III, George H. Strong, C. Sage Givens, John S. Chamberlin, Joel C. Gordon and Larry D. Striplin, Jr. The following guests were also present: William T. Owens, Group Senior Vice President and Controller of the Corporation, William W. Horton, Senior Vice President and Corporate Counsel of the Corporation, Leif M. Murphy, Group Vice President — Finance and Treasurer of the Corporation, William C. McGahan and Howard Capek of Warburg Dillon Read, L.L.C., and Stanley Wiseberg and Samuel H. McGarr of KPMG Peat Marwick. With the exception of Ms. Givens and Messrs. Newhall, Strong, Chamberlin and Gordon, all Directors and guests were physically present. All others participated in the meeting via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Anthony J. Tanner acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 3:00 p.m. C.D.T.

HHEC 18-02103

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**Project Mercury**

Mr. Scrusby informed the Directors that the purpose of this special meeting was to discuss "Project Mercury". He advised the Directors that Messrs. McGahan and Capek would join the meeting to discuss the project from an investment banking perspective, after which Messrs. Wiseberg and McGarr would comment on tax issues relative to the project.

Mr. Scrusby reviewed the various options that the Board had considered during the past year before presenting for discussion the proposed spin-off of the Corporation's inpatient operations. The Board considered the points outlined in the handout detailing the transaction rationale, the configuration and management of the two companies and the preliminary timetable. Mr. Martin reviewed the public debt considerations, financial ratios and pro forma capital structure for the two companies. Mr. Horton discussed the regulatory filings necessary for the proposed transaction and reminded the Directors of the discussion of their fiduciary obligations at the September 16, 1998 meeting at which the proposed transaction was originally discussed. Mr. Owens discussed the audit process that would be undertaken. Mr. Scrusby then presented a summary of the proposed transaction.

Mr. Scrusby invited Mr. McGahan and Mr. Capek to present an investment banking perspective of the proposed spin-off. They discussed their assessment of the potential reaction from the capital markets to the proposed transaction and their perceptions as to the access to debt and equity capital that would be enjoyed by each of the inpatient and outpatient companies on a stand-alone basis.

Mr. Scrusby invited Mr. Wiseberg to review the tax issues that the proposed spin-off transaction would involve. There was an initial discussion centered on the issue of obtaining a private letter ruling from the Internal Revenue Service as opposed to relying on tax opinions without a ruling. Mr. Wiseberg discussed the probable timing advantages of relying on opinions and provided his assessment of the relative risks and benefits of proceeding solely on the basis of opinions. He identified several other transactions that followed the opinion route. He also indicated that the Company would be obtaining a "double opinion", from

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KPMG and Dewey Ballantine. His presentation also covered various pre- and post-distribution issues that needed to be considered.

The Board engaged in extensive discussion of the proposed transaction, including the various business purposes therefor and the issues that would be required to be resolved before a final determination could be made. After such discussion, upon motion duly made by Mr. Gordon and seconded by Mr. Chamberlin, the following resolutions were unanimously adopted:

RESOLVED, that the Chairman of the Board and Chief Executive Officer of this Corporation, the Executive Vice President and Chief Financial Officer of this Corporation, and the other proper officers of this Corporation are hereby authorized and directed to begin development of a plan to separate the Corporation's inpatient and outpatient businesses through the tax-free spin-off of the Corporation's inpatient business, including, but not limited to, development of an appropriate structure for the transaction, development of proposed management teams and organizational structures for the separate companies, development of proposed transitional and shared service arrangements to facilitate the transaction, preparation of any necessary documents for filing with the Securities and Exchange Commission and other appropriate regulatory agencies and such other actions as such officers, upon the advise of counsel and tax advisors, deem necessary or advisable in connection therewith.

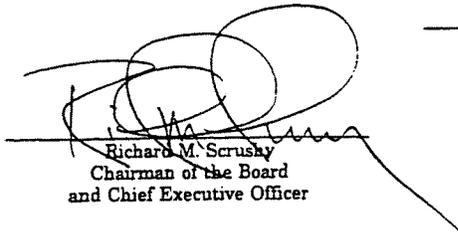
RESOLVED, that such officers are hereby authorized and directed to work with Dewey Ballantine, KPMG Peat Marwick and such other qualified tax counsel and tax advisors as may be necessary or advisable to obtain opinions satisfactory to the Board of Directors with respect to the tax-free nature of the proposed transaction.

RESOLVED, that such officers are hereby authorized and directed to work with the Corporation's investment and commercial bankers to determine an appropriate capital structure for the separate companies and the availability of appropriate debt and equity financing for the separate companies.

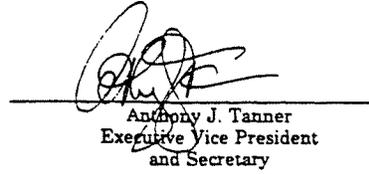
RESOLVED, that the final determination as to implementation of the proposed transaction shall be made by the Board of Directors after receipt of satisfactory tax opinions and the satisfaction of such other conditions as the Board of Directors may determine at such time as a final plan of distribution is presented for approval.

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There being no further business to transact, the Meeting was adjourned.



Richard M. Scrusky  
Chairman of the Board  
and Chief Executive Officer



Anthony J. Tanner  
Executive Vice President  
and Secretary

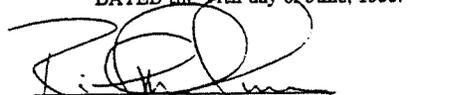
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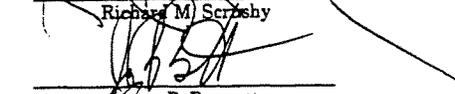
HEALTHSOUTH Corporation

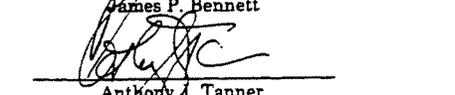
WAIVER OF NOTICE

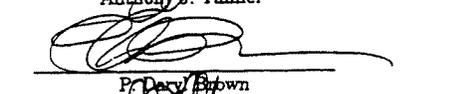
We, the undersigned, constituting all the members of the Board of Directors of HEALTHSOUTH Corporation, a Delaware corporation, do hereby waive notice of the time, place and purpose of the Meeting of the Board of Directors of HEALTHSOUTH Corporation to be held on June 14, 1999, at 3:00 p.m. C.D.T., and we consent to the transaction of such business as may properly become before said Meeting.

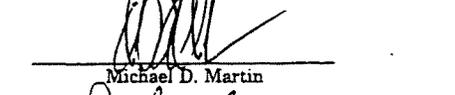
DATED the 14th day of June, 1999.

  
Richard M. Sczesny

  
James P. Bennett

  
Anthony J. Tanner

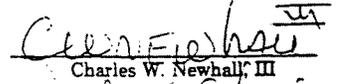
  
P. Daryl Brown

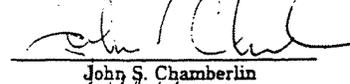
  
Michael D. Martin

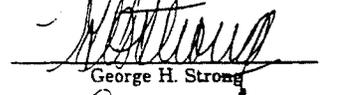
  
Joel C. Gordon

\_\_\_\_\_  
Phillip C. Watkins

  
C. Sage Givens

  
Charles W. Newhall III

  
John S. Chamberlin

  
George H. Strong

  
Larry D. Striplin, Jr.

## UBSW E-Mail

From: Howard Capek  
 Sent: Thursday, August 19, 1999 9:38 AM  
 To: Susan.G.Zeeb  
 Subject: Re: HRC Tab 3

Huh, wedding plans are the least of my worries. In the next 2 weeks, I'll publish on HCR, BEV, GHV, OCR, ALI, CDMC, SNRC, ARC, CSU, ESC, USON, and RSCR. Unfortunately, you and I can combine our next months paychecks and buy enough of all of these names to have to file a 13f next quarter.

Add this coverage roll-out (with industry reports) to a non-deal roadshow with Fresenius in early Sept., and the wedding plans become a welcome distraction.

HRC: I won't publish until this spinout stuff is complete, still restricted (I'd love to publish on this pig, then I wouldn't be spending so much time in Birmingham in July/August; a least there is no humidity).

Okay, on HRC, what is your fax number; I'll send you a few charts and graphs which should glaringly highlight the company's inability to collect and convert sales into cash and also their inability to reinvest cash at good rates of return.

Lets talk today, after you look over the fax.

Hey, did you see Chase eliminated their entire asset management group in NY, traders, PMs, analysts, all gone. I was joking with Mark Attalienti who left Chase in June for a spot in Alliance's small cap fund. It looks like they are making room for Merrill Lynch Asset Management...

Oh well, Speak soon.  
 Howard.

Reply Separator

Subject: HRC  
 Author: Susan.G.Zeeb (Susan\_G\_Zeeb@notes.ntss.com) at unix.mime  
 Date: 8/19/99 9:31 AM

hello there. boy you must be having a relaxing summer, no reports to write, no clients to pester. JUST KIDDING.  
 when are you going to publish?? I'm sure you're getting tied up with final wedding plans--that's coming up next month, right??  
 seriously, what's up with this one?? is it managed care pricing, the DSOs, or what??? it's acting like such a pig again.  
 susan

UBSW E-Mail

---

From: Howard Capek  
Sent: Friday, September 10, 1999 12:25 PM  
To: Susan.G.Zeeb  
Subject: Re: HRC Tab 4

I am with you on the heavily drinking thing. Especially since tonight and tomorrow is my bachelor party. Casual dinner tonight, Yankee/RedSox game tomorrow and dinner at Sparks tomorrow night. I might sleep right through opening day NFL on Sunday....

HRC, what a mess. I would not own a share. We need to speak on this one.

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## UBSW E-Mail

From: Richard Dalton  
 Sent: Monday, September 27, 1999 1:41 PM  
 To: Howard Capek; Austin Burkett  
 Cc: DL-WIRE-Database-Team-Americas  
 Subject: Re: Healthsouth

Tab 5

Howard, Austin

I haven't heard anything re. Healthsouth being back on the restricted list. Presuming it is not, are you ready for us to publish forecasts/rating in this month's Analyzer?

Thanks,

Richard

Reply Separator

Subject: Re: Healthsouth  
 Author: Richard Dalton at i-am.n.newyork,equity-research  
 Date: 9/17/99 9:02 AM

Bill

Is it right that we're restricted again on Healthsouth? Compliance removed if from their restricted list but Howard thinks it may have gone back on. Please could you confirm.

Thanks,

Richard

Forward Header

Subject: Re: Healthsouth  
 Author: Howard Capek at i-am.n.newyork,equity-research  
 Date: 9/15/99 4:51 PM

Richard,  
 Check with Bill McGahan in banking, but I think I'm restricted again on HRC

Reply Separator

Subject: Healthsouth  
 Author: Richard Dalton at i-am.n.newyork,equity-research  
 Date: 9/14/99 9:05 AM

Howard, Austin

We note that Healthsouth has come off the restricted list. Are you ready for your forecasts to be 'public' again?

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UBS/C 066172

ard

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UBS/C 066173

UBSW E-Mail

---

**From:** Howard Capek  
**Sent:** Tuesday, September 14, 1999 9:19 AM  
**To:** Richard Dalton  
**Cc:** Austin Burkett; DL-WIRE-Database-Team-Americas; Howard Capek  
**Subject:** Re: Healthsouth

Not yet. Will circle back at end of business today. Should be ready to reinstate coverage by Thursday.

Reply Separator

---

**Subject:** Healthsouth  
**Author:** Richard Dalton at i-am,n,newyork,equity-research  
**Date:** 9/14/99 9:05 AM

Howard, Austin

We note that Healthsouth has come off the restricted list. Are you ready for your forecasts to be 'public' again?

Regs.

Richard

## UBS E-Mail

From: Capek, Howard  
 Sent: Thursday, October 25, 2001 10:45 AM  
 To: 'Dan Martin'  
 Subject: RE:

Tab 6

To your questions:  
 Don't know, yes, and yes!!!.

These past two weeks, I don't think people have been selling based on valuation on next years forecast. It has been much more based on "how much am I up in the stock, and which can I sell out of my overall hc service portfolio", which becomes an LTM results decision.

11: pricing in the top 7 managed care contracts?? I've said all along HRC's pricing cycle is 1-2yrs behind that of the hospitals (just a function of managed care mix and how payors look at outpatient contracts); '02 should be to HRC's pricing as was '01 to the hospitals.

If you can buy here, I would.

Howard Capek  
 Executive Director, Healthcare Research  
 212-713-3663

-----Original Message-----  
 From: Dan Martin [mailto:DMartin@StandardPacific.com]  
 Sent: Thursday, October 25, 2001 10:35 AM  
 To: Capek, Howard  
 Subject:

why are they whacking HRC? because no balance sheet data int eh release?  
 aren't these guys gonna be reporting \$1.10-\$1.15 when all is said and done next yr?

Daniel S. Martin  
 Standard Pacific Capital  
 425 California Street  
 26th Floor  
 San Francisco, CA 94104

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 REQUESTED BY UBSW

UBSW/C 035033

## UBS E-Mail

From: Capek, Howard  
 Sent: Friday, September 27, 2002 12:30 PM  
 To: 'Rich Schneider'  
 Subject: RE: HRC Tab 7

Agreed. I did ask that question on the conference call ("...short of your resignation Richard, what can you do to address the share price?"), although he danced around it quite well...

Have a good weekend sir.

Howard Capek  
 Managing Director, Healthcare Research  
 212-713-3663

-----Original Message-----

From: Rich Schneider [mailto:RICH.SCHNEIDER@usa.dupont.com]  
 Sent: Friday, September 27, 2002 11:28 AM  
 To: Capek, Howard  
 Subject: RE: HRC

the only relevant question about Scrusby is whether he will recognize that he needs to GO. My own view is that he may have good legal defenses on his stock sales, but that morally he is a cancer on the company. What questions can I have from there?

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 REQUESTED BY UBSW

UBSW/C 037618

## UBS E-Mail

To: Noble, Michael V. Tab 8  
 Subject: RE: He just doesn't get it

This doesn't appear to be his doing. The Board acted, which is a bit unclear to me. This does insure that Scurshy

**Howard G. Capek**  
 Managing Director  
 U.S. Equity Healthcare Research  
 direct: 212-713-3663  
 mobile: 917-613-6016  
 howard.capek@ubsw.com <mailto:howard.capek@ubsw.com>  
 www.ubswarburg.com <http://www.ubswarburg.com>

## -----Original Message-----

From: Noble, Michael V.  
 Sent: Tuesday, January 07, 2003 8:54 AM  
 To: Capek, Howard  
 Subject: He just doesn't get it

Amazed he puts himself back into the CEO spot, with absolute disregard for the reaction from the markets, and blows any rally in his shaky company. Guess back when I learned of this idea I should have paid more attention to the "mgt. not really liked on Wall St." element...because it's a gift that just keeps giving. Obviously he does not own enough stock, got out of enough stock, and figures given a healthy personal cash reserve he can simply wait for better years...even if they are two or three years away. Rarely do you see such disregard for shareholders. The board should boot this guy and sell the company, but that looks equally impossible. Does he even care about the reaction in the markets? He cannot be that stupid, so he is that arrogant...and that means long term trouble no matter how good they do. Unbelievable. MN

<< OLE Object: Paintbrush Picture >>

Michael V. Noble  
 Sr. Vice President/Corporate Services Group  
 UBS Tower  
 One North Wacker Drive, Suite 2500  
 Chicago, IL 60606  
 Phone: 312-525-4576  
 Fax: 312-525-4773  
 800-621-0684

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 REQUESTED BY UBSW

UBSW/C 038157

UBS E-Mail

---

**From:** Capek, Howard  
**Sent:** Wednesday, January 08, 2003 10:01 AM  
**To:** Noble, Michael V.  
**Subject:** RE: He just doesn't get it

See my note?

I don't think this was his doing, although he is very happy about it.

The board acted for the sake of acting, I think. No necessarily the right thing to do, but it was done. The board was disappointed with McVay as CFO, I believe. Not that they should have been disappointed with themselves, Scrusby and the whole lot.

I think Bill Owens is the right guy to "fix" things. To the extent that he is back in the CFO role and THE most important act needed to restore any semblance of confidence is cap-ex discipline, maybe this is a blessing in disguise.

Howard G. Capek  
Managing Director  
U.S. Equity Healthcare Research  
direct: 212-713-3663  
mobile: 917-613-6016  
howard.capek@ubsw.com  
www.ubswarburg.com

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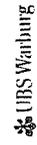
UBSW/C 038158

Case Studies: Selected Long Term UBS  
Warburg Relationships

SECTION 3

Tab 9

B UBS Warburg and HealthSouth



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UBS/C 148618

NUMBER 148619

### UBS Warburg and HealthSouth – Corporate Finance Relationship

❖ Over the course of this relationship, we have helped HRC raise over \$3.6bn through 13 debt and equity financings and advised on 19 M&A Transactions worth \$7.7bn

Selected HealthSouth Transactions Since IPO

*1, 6, 7*

Financings	
Sep 01	\$600mm Senior Notes
Jan 01	\$375mm Senior Notes
Oct 00	\$587mm Senior Credit Facilities
Sep 00	\$350mm Senior Sub Notes
Jun 98	\$250mm Senior Sub Notes
Mar 98	\$567mm Cvt Subordinated Notes
Sep 95	\$350mm Secondary Equity Offering
Mar 94	\$250mm Senior Sub Notes
Mar 94	\$115mm Cvt Subordinated Notes
May 91	\$74mm Secondary Equity Offering
Jun 90	\$57mm Secondary Equity Offering
May 89	\$50mm Cvt Subordinated Notes
Sep 86	\$13mm Initial Public Offering

*1, 6, 3*

Advisory	
Jul 99	\$50mm Acquisition of American Reliability Services
Jul 98	\$590mm Acquisition of National Surgery Centers
Jul 98	\$500mm Acquisition of 33 Surgery Cntrs from Columbia/HCA
Jun 98	\$25mm Acquisition of The Company Doctor
Dec 97	\$1,250mm Sale of Horizon UT Carefirst Pharmacy Bus to HFS
Oct 97	\$1,650mm Acquisition of Horizon/CMS Healthcare
Oct 97	\$185mm Acquisition of ASC Network Corporation
Jul 97	\$270mm Acquisition of Health Innspus, Inc
Dec 96	\$70mm Acquisition of RoadieCare
Aug 96	\$70mm Acquisition of Professional Sports Care Mgmt
Mar 96	\$345mm Acquisition of Advantage Health
Jan 96	\$1,400mm Acquisition of Surgical Care Affiliates
Dec 95	\$125mm Acquisition of Caronark Orthopedic Services, Inc
Dec 95	\$60mm Acquisition of Sutter Surgery Centers
Jun 95	\$240mm Acquisition of Surgical Health Corp
May 95	\$245mm Acquisition of Hospicare Rehabilitation Hosp - Oregon
Dec 94	\$220mm Acquisition of Rohlf
Jun 94	\$40mm Acquisition of Diagnostic Health
Jun 94	\$365mm Acquisition of HIAE Rehabilitation Division



**Case Study: UBS Warburg and HealthSouth**

❖ **UBS Warburg's Healthcare team has successfully developed a strong partnership with HealthSouth over the past 16+ years**

HealthSouth Corporation is the largest provider of outpatient surgery and rehabilitative healthcare services in the United States. The Company provides these services through its national network of inpatient and outpatient healthcare facilities, including inpatient and outpatient rehabilitation facilities, outpatient surgery centers, diagnostic centers and other healthcare facilities. HealthSouth presently maintains 1,975 patient care locations in 50 states, the United Kingdom and Australia.

**Key Facts**

Headquarters	Birmingham, Alabama
Ticker Symbol	HSC (NYSE)
2001 Revenue (mm)	\$4,380.5
2001 EBITDA (mm)	\$1,200.4
Market Cap (as of 5/7/02)	\$5,728.5
Credit Rating	
Lombard's	B-2
S&P	BBB-



## UBS Warburg and HealthSouth – Equity Research Relationship

Date	Headline	Rating
02/05/02	HIC: Highlights from the Healthcare Services Conference	Strong Buy
09/02/01	HIC: Strong 2Q, All Factors, Leaving Hospital	Strong Buy
05/22/01	HIC: Sentiment An Old Issue, Reiterate Strong Buy	Strong Buy
04/27/01	HIC: Fine 1Q Results, How Best to Look to Growth	Strong Buy
02/28/01	HIC: Reiterate Strong Buy on Light of Global Deal News	Strong Buy
02/06/01	HIC: Highlights from the Healthcare Services Conference	Strong Buy
01/11/01	HIC: Operating on Strength and Potential	Strong Buy

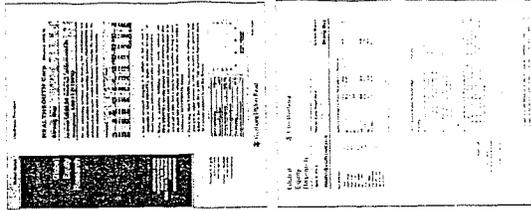
### UBS Warburg also provides a platform for HealthSouth to raise its market profile and awareness

- HealthSouth has presented at the following UBS Warburg Conferences
  - February 2002, Global Healthcare Services Conference, The Plaza Hotel, New York
  - HealthSouth was the keynote lunch presentation at the Conference
  - February 2001, Global Healthcare Services Conference, The Plaza Hotel, New York
    - HealthSouth was showcased on a special day of presentations where only a select 14 top Healthcare Services companies were allowed to present
  - February 2000, Global Healthcare Services Conference, The Plaza Hotel, New York

### UBS Warburg Sponsored Non-Deal Roadshows

Date	Location	Days	# of Accounts
Nov 2000	UK <sup>1</sup>	2	12
Mar 2001	California <sup>2</sup>	3	25
Jun 2001	Denver	1	7
Oct 2001	Boston	1	9

<sup>1</sup>NYC  
<sup>2</sup> San Francisco, Los Angeles, San Diego



FINANCIAL RISK

### UBS Warburg Trading Support for HealthSouth

❖ UBS Warburg is a top trader of HealthSouth Stock

#### January 1, 2002 to Present

Broker	Volume Traded (000s)	Market Share (%)
Lehman Brothers, Inc.	37,698	12
Salomon Smith Barney, Inc.	16,705	11
JP Morgan H&Q	29,630	9
Merrill Lynch, Pierce Fenner & Smith	22,372	7
<b>UBS Warburg</b>	<b>19,668</b>	<b>6</b>

SOURCE: FINANCIAL RISK

#### January 1, 2001 to December 31, 2001

Broker	Volume Traded (000s)	Market Share (%)
Lehman Brothers, Inc.	73,721	10
Salomon Smith Barney, Inc.	55,981	8
Goldman Sachs Group	54,894	8
Credit Suisse First Boston	47,809	7
<b>UBS Warburg</b>	<b>42,493</b>	<b>6</b>

Current UBS PaineWebber Retail Holdings in HealthSouth: \$92 million



## MEMORANDUM

TO: Leveraged Finance Commitment Committee ("LFCC")  
Credit Risk Management Americas ("CRM")

FROM: Mike Leder ~~Alex Goff~~  
David Beldin ~~Dan Ladd~~  
Frank Berman

~~Bill McGahan, Rod O'Neill, Prasad Poddar, et al.~~

RE: HealthSouth Corporation / MedCenterDirect, Com, Inc.

DATE: March 27<sup>th</sup>, 2001

Tab 10

## Leveraged Finance Commitment Committee Meeting

New York: Wednesday, March 28th, 2001

Time: 2:00 p.m. (US), 8:00 p.m. (UK)

Call-in Number (US): 1-877-847-0304

Call-in Number (Int'l): 1-630-424-7723

Passcode: 6870369#

Host: Chris Ryan

## EXECUTIVE SUMMARY

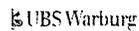
The purpose of this memorandum is to obtain approval to provide MedCenterDirect, Com, Inc. ("MedCenterDirect" or the "Company") with a \$15 million 7-months term loan facility (the "Facility"). HealthSouth Corporation ("HealthSouth"), which owns 20% of MedCenterDirect, will guarantee 100% of the loan. Additionally, in order to make this loan a credit neutral event for UBSW, HealthSouth has agreed to reduce access to its existing \$400 million revolving credit facility (the "Revolver") to \$345.0 million, which has the effect of reducing UBSW's credit exposure to HealthSouth by \$15 million.

This financing is purely a relationship concession to HealthSouth, with the full sponsorship of UBSW's HealthCare CFD team. HealthSouth is a key relationship for CFD and LFG having generated more than \$[9] million in financing fees over the last 9 months. We expect that this flow of lead managed business will continue as HealthSouth continues to term-out its bank debt.

## COMPANY OVERVIEWS

MedCenterDirect was founded in 1999 with the backing of HealthSouth to develop and implement an online business-to-business e-commerce marketplace for the purchase and sale of medical supplies to hospital and other healthcare providers. Today, MedCenterDirect is a fully operational e-procurement company offering four integrated management services through its web site ([www.medcenterdirect.com](http://www.medcenterdirect.com)). Though the Company currently provides solutions to approximately 1,000 healthcare facilities across the U.S., it has not recorded positive cash flow so far.

The following table summarizes the historical and projected performance of the Company



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UBS/C 102498

**TRANSACTION STRUCTURE**

HealthSouth has asked UBS Warburg to provide MedCenterDirect with a \$15 million term loan facility. MedCenterDirect will use a portion of the term loan proceeds to pay back existing HealthSouth liabilities. Given the start-up status of MedCenterDirect, the Facility will be fully guaranteed by HealthSouth. In order not to increase our overall existing credit exposure to HealthSouth, HealthSouth will commit to limit its potential drawings under their existing 364-day Revolver with UBSW to \$345.0 million, which will reduce UBSW's credit exposure to HealthSouth to \$15 million for the duration of the loan to MedCenterDirect. This number is based on the following considerations:

- Size of 2000 revolving credit facility (the "Revolver"): \$400.0 million
- UBS Warburg's maximum hold according to last years credit approval: \$109.8 million
- UBS Warburg's corresponding pro-rata share within syndicate: 27.45%
- UBS Warburg's new exposure to HealthSouth/MedCenterDirect: \$15.0 million
- Required carve-out amount in order to our keep pro-rata share of 27.45%: \$54.6 million
- Reduced availability under \$400 million revolving credit facility: \$345.0 million

**SUMMARY TERMS**

<b>Borrower:</b>	MedCenterDirec.Com, Inc. ("MedCenterDirect")
<b>Guarantor:</b>	HealthSouth Corporation ("HealthSouth")
<b>Arranger:</b>	UBS Warburg LLC
<b>Senior Credit Facility:</b>	US\$15 million Term Loan ("Term Loan")
<b>Maturity:</b>	Co-terminus with availability period of the \$400 million 364-day Revolving Credit Facility ("Revolver") maturing in October 2001
<b>Drawn Pricing:</b>	As per Revolver
<b>Representations and Warranties:</b>	As per Revolver (to include HealthSouth)
<b>Conditions Precedent:</b>	As per Revolver (to include HealthSouth)
<b>Financial Covenants:</b>	As per Revolver (to include HealthSouth) <i>including debt not limited</i>
<b>Affirmative and Negative Covenants:</b>	As per Revolver (to include HealthSouth)
<b>Events of Default:</b>	As per Revolver (to include HealthSouth)
<b>Conditions to Commitment:</b>	Satisfactory side letter from HealthSouth committing to limit its drawings under the Revolver to \$345 million
<b>Underwriting Fee:</b>	US\$150,000

**TRANSACTION RELATED ISSUES**

**Disclosure Requirement for HealthSouth.** According to the HealthSouth, there will be no further reference to this 'cosmetic' transaction in its financial statements due to the following reasons

- (1) HealthSouth currently holds approximately 20% in MedCenterDirect. Therefore, it does not consolidate its stake in MedCenterDirect.
- (2) HealthSouth will not have to report its guarantee to MedCenterDirect in its financial statements. Based on HealthSouth's actual availability under its existing credit facilities, the size of the guarantee will be assessed immaterial by the accountants

 UBS Warburg

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 102500

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APPENDIX

A Financial Model for year 2000 Transaction

 UBS Warburg

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 102501

MedCenterDirect  
Ownership Analysis

Owner	Stock Type	Shares (000s)	Dollars (000s)	Ownership <sup>(1)</sup> %
HealthSouth Corporation	Series A	6,390	\$2,210	23.3%
Marin Family LP (Richard Schrushy)	Series A	5,494	\$1,900	20.0%
NEA (New Venture Associates)	Series E	4,800	\$12,000	17.5%
Other Series A (Family, Board Members)	Series A	4,100	\$1,418	14.9%
Rob White (CEO)	Common	2,700	\$3	9.8%
Bret Grauss (COO)	Common	825	\$1	3.0%
Mike Martin (former HealthSouth CFO)	Series A	723	\$250	2.6%
Richard Scruschy Charity (HealthSouth Related)	Series A	578	\$200	2.1%
Kraeiling (former CIO of MCD)	Common	385	\$0	1.4%
Maddox	Common	100	\$0	0.4%
Bob Coe (Board of Directors)	Common	100	\$35	0.4%
Dan Lochridge (Physician)	Series B	300	\$250	1.1%
Bob Coe (Board of Directors)	Series C	200	\$200	0.7%
Knott (Physician)	Series C	50	\$50	0.2%
Individual Investors (Friends, Family)	Series D	700	\$1,750	2.6%
<b>Subtotal</b>		<b>27,445</b>	<b>\$20,267</b>	<b>100%</b>
Employees	Options / Warrants	3,864		
Board / 3rd Party	Options / Warrants	2,136		
<b>Total</b>		<b>33,445</b>		

Note 1 – ownership based on shares.  
Total Ownership related to HealthSouth =

48.0%

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REQUESTED BY UBS

UBS/C 102684

## UBS E-Mail

From: McGahan, William+  
 Sent: Tuesday, October 02, 2001 11:04 AM  
 To: O'Neill, Roderick+; Lorelio, Benjamin+  
 Subject: Fw: Re.

Tab 11

Fyi

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: Owens, Bill <Bill.Owens@healthsouth.com>  
 To: McGahan, William+ <William.McGahan@ubsw.com>  
 Sent: Tue Oct 02 10:12:06 2001  
 Subject: Re:

Thanks for all of your hard work. Once again, you proved to be a great partner. You and Ben have done so much for us over the years. You have played a big part in our success.

Thanks for the invite for golf, but I will not be able to do it. Our golf outing is on Tuesday afternoon, and the meetings are Wednesday and Thursday. I can be flexible with your presentation time, if that will help you to be able to participate. Auburn and Alabama are playing on that Saturday, so I can't go to Kiawah for the weekend either. Don't forget me next year.

William T. Owens  
 HEALTHSOUTH Corp.

-----Original Message-----

From: McGahan, William+ <William.McGahan@ubsw.com>  
 To: Owens, Bill <Bill.Owens@healthsouth.com>  
 Sent: Mon Oct 01 19:56:43 2001  
 Subject:

Congrats again on a great bond deal. The market for equity and debt is going to continue to get worse - I fear - as earnings for the 3rd and 4th quarter fail to materialize. So it was smart to grab it while you could.

Second subject: want to try to get into the UBS Warbug / Sr. Ryder cup on Nov 14th and or 15th? Is a direct overlap of the board meeting. The pro-am is on Weds/Thurs, so I'd the meeting is earlier in the week maybe we can sneak up to Kiawah. Let me know.

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

Visit our website at <http://www.ubswarburg.com>

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UBS/C 080964

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UBS/C 080965

## UBS E-Mail

**From:** McGahan, William+  
**Sent:** Saturday, October 13, 2001 6:21 PM  
**To:** 'bill.owens@healthsouth.com'  
**Cc:** O'Neill, Roderick+; Pucciarelli, Philip+

Tab 12

I think that we could do a number of things at the board meeting.

- 1) I think we ought to compare where we were (capital structure, access to capital, cost of capital, reliance upon banks, where our debt was trading on a yield to maturity, etc...) at the end of last summer vs. where we are today. The obvious conclusion is that you guys have taken the company from near death to very healthy very quickly.
- 2) look at the next challenges: the bank line expiring, the converts coming due. The options we have to get the bank debt down over the next 6 to 12 months (cash flow from operations, asset sales, converts, more senior notes, etc...)
- 3) we should look at what the analysts were saying then versus what they are saying today. Are they factoring in the upside of PFS?
- 4) look at the new institutions that have come into the stock over the last year.
- 5) look at the future. Medicare cuts are going to happen, and commercial payors will tighten again - its a question of when. What does that mean to us.
- 6) lastly, other opportunities (M&A). When do we play offense again?

Anyway, early thoughts.

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

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UBS/C 080939

Kusmierz, Kristin+

From: Garson, Raymond [UBS]
Sent: Wednesday, December 19, 2001 9:54 AM
To: Kusmierz, Kristin+; Pucciarelli, Philip+
Cc: Crockett, John+ [UBS]
Subject: RE: HCI LFCC Memo

Tab 13

has on model

At first read I have a few questions and/or comments as follows:

Where is the model? As we will need it for both the pre and actual LFCC

Need to add transaction rationale: why is HRC selling assets below market or alternatively why is HCI setting rents so low.

Discuss our borrowers go-forward business plan, what are they going to due, where are they going to get the money and what is the expected timing. again we need a full model to see what our borrower looks like.

timeline for HCI IPO

Need to add a legal organization chart for Cambridge, which specifically includes HCI and our SPV borrower as well as specific assets and liabilities (debt maturities) at each respective entity.

section discussing Cambridge what else it owns, what debt it has, who owns the equity (does any HRC management or related parties own part of Cambridge or HCI??), etc. Also discuss how Cambridge will interact with HCI going forward (cross-management, inter-company loans, shared services, dividends, guarantees, etc)

add back Cambridge section

Discuss the private equity raise (did this fail or was it pulled or what?)

we need to fill-out the covenants in the term sheet

why are we not secured by the deeds to the properties as well as the HRC lease stream?

are Cambridge and HCI guaranteeing the loan? if not why?

When does HCI expect to gain REIT status, and what specifically does it still need to due in terms of legal requirements? Has REIT counsel reviewed the proposed structure to see if there are any problems (to HCI proposed REIT status) as a result of the HRC keepwell?

update on HCI's REIT process

Will HRC have to disclose the keepwell agreement in its financial statements, if so where (contingent liability footnote?)

Add a table of all of HRC's off balance sheet liabilities (guarantees, keep-wells, etc) including a debt schedule

Table HRC debt schedule - list all maturities

In memo you say the HRC keepwell agreement requires that HRC purchase the properties at "fair market value" how is fair market value specifically defined in the keepwell (should be summarized in the memo) and what are our rights if FMV is below our outstanding loan amount.

-> in keepwell b/w cause fmv

Does our loan have any amortization requirements or extension options?

If no amortization what do we expect our borrower to do with the rent payments it receives after interest expense? Can we block dividends up to various Cambridge entities (especially ones that will not be guarantying our loan)?

I'm sure there will be more later, but that's all I have for now.

rw  
x6415

-----Original Message-----

From: Kusmierz, Kristin+  
Sent: December 18, 2001 8:26 PM  
To: Leder, Michael+; O'Neill, Roderick+; Pucciarelli, Philip+; Wollard,  
Scott+; Crockett, John+; Garson, Raymond  
Cc: Kusmierz, Kristin+  
Subject: HCI LFCC Memo

Please find attached a preliminary draft of the Healthcare Capital  
Investors LFCC memo. Please respond with any  
comments/suggestions by noon on Wednesday, as the final revised copy  
will be distributed Wednesday afternoon.

Kristin Kusmierz  
Global Healthcare  
UBS Warburg LLC  
Tel: 212-821-3445  
Fax: 212-821-6863

<<AppendixE\_VTR.pdf>> <<AppendixE\_HCN.pdf>> <<AppendixE\_HR.pdf>>  
<<AppendixE\_Industry.pdf>> <<AppendixE\_SNH.pdf>>  
<<HCI\_LFCC V12.18.01.doc>>



**PROJECT DESCRIPTION**

In addition to the description, this section should seek to address all issues relevant to the decision being sought (product type, reputational issues, potential conflicts, prospects for future business, deal structure, etc.)

- \$82.2 million, 12-month LIBOR-based loan to First Cambridge HGI Acquisitions, LLC, a SPE consisting solely of 14 HEALTHSOUTH properties
- The loan is priced at LIBOR + 175bps resulting in a \$1.030 million make whole
- The loan is 100% guaranteed by HEALTHSOUTH
- Proceeds from the loan will be used to purchase 14 HEALTHSOUTH properties
- Based on annualized 9/30/01 numbers, the properties generate \$120.0 million in revenues and \$40.7 million in EBITDA
- First Cambridge has set the cap rate at 10.5% yielding \$8.4 million in rents resulting in EBITDA:rent coverage of 5.1x
- The loan is essentially a "bridge" to an IPO estimated to be conducted within the first 6-9 months of 2002. UBS Warburg has been identified as the sole bookrunning manager
- UBSW has had multiple discussions with HEALTHSOUTH regarding the refinancing of HRC's \$1.75 billion Senior Credit Facility to be

Opportunities for cross product selling to the client in this project (eg. Cross selling of financing products, FX, treasury products, etc.) (date of internal discussion which have taken place to date)

**OTHER INFORMATION**

Conflict clearance note sent? (1)(2)(3):	No	Covered by UBSW Equity Research Analysts:	No
Positive clearance received from Compliance?	No	Have you notified/cleared the transaction with:	
If No, why was Compliance not notified?		ECMG	No
Cleared with industry sector head? (3):	Yes	Please state contact name/s:	
Please state contact name/s:	Benjamin Lorello	DCMG (4)	Yes
Cleared with country team? (3):	Yes	Equity Research (4)	No
If No, why was not cleared with a Country Team?		Treasury Products (4)	No
If it is a European transaction, is the transaction within guidelines (5) or staffed by the Mid Market Group or CFD Switzerland?		Credit Risk informed?	Yes
If No, which member(s) of the M&A Steering Group approved the transaction?	#N/A	Have you complied with all relevant white book procedures?	Yes
Financial Sponsor group consulted?	Not Applicable	Type of BRG meeting:	Weekly

Relevant product group contacts for CFD:  
**DCMG** - Andrew Dennis - permanently inside the CFD Chinese Wall  
**FX** - **NOTE:** When a CFD caller contacts the FX contact below about a potential project, the caller should state that they are going to state that individual over the Chinese Wall before providing actual client and project details. The non-CFD person should note their compliance status outside the Chinese Wall.  
 Europe (ie. Switzerland): Leslie Grant and Mar-Kin (permanently inside the CFD Chinese Wall) / Anne Summerland  
 Switzerland: Maria Wiseman  
 Americas: Elen Schubert  
 Asia Pacific: Sam Cones  
**CREDIT RISK** - Ian Fice  
 David Swinden - Japan

(1) See CD of the White Book (2) Should virtually always be "yes" (3) Mandatory to explain why if "no" (4) Subject to Chinese Walls (see notes above) (5) Above €200m or €200m for ACT (date: ...)

## Addendum, First Cambridge HCI Acquisitions, LLC

### EXECUTIVE SUMMARY

UBS Warburg will act as Lead Arranger on a 12-month, \$82.2 million senior secured term loan to First Cambridge HCI Acquisition, LLC (HCI) a special purpose entity (the "SPE" or "Borrower"). The SPE is a stand-alone entity with its own corporate governance run by Bill Harlan, President, and 100% owned by Jean-Claude Saada. The SPE has is currently negotiating the purchase of 14 HEALTHSOUTH ("HRC") properties (a diversified mix of properties that collectively produce, for the 9-months ended 9/30/01 annualized, \$120.0 million in revenues and \$42.7 million in EBITDA). HCI intends to enter into a sale-leaseback transaction with HRC for the properties for an estimated purchase price of \$80.0 million. This credit facility will be secured by the lease stream payments owed to the Borrower by HEALTHSOUTH Corporation and 100% guaranteed by HEALTHSOUTH. The properties will be triple-net leased, under one master lease agreement, for fifteen years with the option to extend the lease agreement in annual increments after the initial expiration of the master lease. HRC will also maintain the option to buy back these facilities upon expiration of the initial master lease. The cap rate has been established at 10.5% yielding approximately \$8.4 million in rental income for HCI. UBS will in effect be exposed to HRC credit risk, as HRC will be the tenant of all 14 properties, and HRC is bound by a duly executed Keepwell Agreement. HCI will establish the SPE, consisting of HRC properties, as the platform for its proposed REIT and intends to close additional acquisitions of selected healthcare properties within the first 3-6 months of 2002. HCI intends to establish a total portfolio of approximately 25-30 properties (that produce in excess of \$200 million in revenues and \$60-70 million in EBITDA) within the first 3-6 months of 2002 and simultaneously conduct an Initial Public Offering ("IPO") (for the newly formed REIT) for which UBS Warburg has been identified as the Sole Bookrunning Manager.

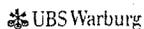
The SPE is formed to hold the 14 HRC properties. HCI will acquire additional properties to build upon the 14 properties that will function as anchor properties for the REIT. HCI will acquire an additional 10-15 properties before going public as a REIT in early 2002. The proceeds from the IPO will be used to pay-off the \$82.2 million loan.

### HEALTHSOUTH RATIONALE

- HEALTHSOUTH has a vested interest in developing a relationship with HCI in order to secure a flexible and expedient "financing" vehicle for future sale-leaseback transactions
- In addition, HRC also stands to benefit from a long-term relationship with Cambridge, a leading developer of medical facilities.
- Finally, HEALTHSOUTH will use the proceeds from the property sale to pay down existing debt – assisting in fulfilling its goal of continuous debt reduction

### HEALTHSOUTH KEEPWELL AGREEMENT

The HCI Credit Agreement for \$82.2 million will include a Keepwell Agreement in the form of a side letter agreement. HRC will be bound by the Keepwell Agreement in the event of a default and/or foreclosure on any of the 14 properties that are in one master lease. The Agreement will cover the entire loan amount.



**CAMBRIDGE HOLDINGS AND HCI**

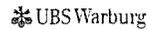
Cambridge Holdings, Inc., a Dallas-based real estate firm specializing in the development, acquisition, ownership, management and disposition of highly integrated, state-of-the-art, income-producing healthcare properties, was founded by Jean-Claude Saada in 1987. These properties include medical office buildings ("MOBs"), integrated medical facilities, ambulatory surgery centers, diagnostic clinics, physician clinics and specialty hospitals.

Members of the Cambridge team have successfully acquired, developed, re-developed, re-positioned and managed \$1.2 billion in healthcare real estate. Cambridge specializes in the development and operation of all types of highly integrated, state-of-the-art healthcare facilities that serve the strategic goals of its partners while facilitating convenient delivery of healthcare services to patients. These projects are typically developed in off balance sheet arrangements that do not add assets and management burdens to the hospitals' holdings but still provide the advantage of new state-of-the-art facilities that attract physicians and their patient referrals into the hospitals. Cambridge's current strategy expands its reach beyond hospital campuses to include similar arrangements with non-hospital operators of ancillary, off-campus facilities.

The Cambridge team has acquired and developed 160 healthcare facility properties totaling 8 million square feet.

Bill Harlan established HCI in February 1999 as a privately held real estate investment entity specializing in the acquisition of income-producing healthcare properties that are leased to healthcare operators. In July 2000, Mr. Harlan merged HCI into Cambridge Holdings, Inc. For the purpose of this transaction, HCI will form a special purpose entity, which will be a wholly owned subsidiary of HCI, and function exclusively as a REIT.

Bill Harlan's expertise in healthcare financing and his broad base of relationships gained during 25 years' experience in healthcare property acquisition is invaluable to Cambridge. Bill joined Cambridge when his firm, Healthcare Capital Investors (HCI), merged with a subsidiary of Cambridge. Prior to the formation of HCI, he was a founding member of executive management for Capstone Capital Corporation, formerly a Birmingham, Alabama-based publicly traded healthcare REIT. Bill served as Senior Vice President and head of Acquisitions and Development at Capstone. He was the primary officer responsible for Capstone's healthcare property acquisitions (including negotiating, underwriting and structuring) and portfolio growth. When Bill left Capstone in 1997, the company's portfolio stood at more than \$700 million in 120 diversified healthcare properties nationwide. Before his affiliation with Capstone, Bill spent nearly 20 years at Southtrust Bank where he founded the bank's healthcare division and managed it for 15 years. He developed project financing for more than 50 healthcare facilities and more than \$500 million in transactions. Bill holds a Bachelor's Degree in Finance from Auburn University.



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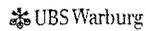
**RELATIONSHIP WITH HCI & HRC**

Ben Lorello and Bill McGahan's relationship with Bill Harlan, President of HCI, dates back to Capstone Capital Corporation, a publicly traded healthcare REIT, where Bill Harlan was a member of senior management and Tadd McVay served as CFO (currently treasurer of HEALTHSOUTH).

Ben Lorello and Bill McGahan have maintained a strong and long-standing relationship with HRC for over 15 years. In that time they have completed 33 transactions in a lead role, totaling \$11.6 billion. In the past 12 months alone, UBSW has served as Sole Bookrunner and Lead Manager on three HRC debt offerings totaling approximately \$1.3 billion:

- ◆ \$600 million Senior Notes Offering on September 24, 2001
- ◆ \$375 million Senior Notes Offering on January 25, 2001
- ◆ \$350 million Senior Subordinated Notes on September 20, 2000

*Upcoming Transaction:* HRC will be refinancing its existing \$1.75 billion Credit Facility in the first three months of 2002 which will be coupled with a corporate finance transaction. UBSW expects a very senior role in both transactions.

**UBS/C 148588****CONFIDENTIAL TREATMENT  
REQUESTED BY UBS**

**UBSW**

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**From:** O'Neill, Roderick+  
**Sent:** Friday, March 15, 2002 1:07 PM  
**To:** McGahan, William+  
**Subject:** HEALTHSOUTH REIT

Tab 15

Bill,

I want to make sure we are doing nothing wrong on the HEALTHSOUTH REIT. This is the current ownership of the REIT. No one has put any money into it and they want to designate ownership to a significant other, i.e. wife, daughter, etc. Do you think there will be a problem with this when and if they go public?

Richard Scrusby's daughter 20%  
Bill Owens 10%  
Horton 5%  
Tad 5%  
Weston 5%  
Richard Davis 3%  
Jason Brown 1%

Bill Harlin 25.5%  
Jean Claude 25.5%

**Attendees:**

**Committee Members:** Chris Ryan (Chairman), Brian McBride (GSF), David Juge (Syndication), Bill Glass (CRC), Alex Geier (for Steve Ruggiero), Oliver Trumbo (Counsel) and Christian Rothhardt (Minutes)

**Deal Team and others:** Rod O'Neill (CFD), Scott Wollard (CFD), Andreas Wyler (CRC), David Goldman (CRC), Renata Jacobson (LPRM)

**TRANSACTION:** MedCenterDirect.Com, Inc.

Approval sought to increase the amount and extend the maturity of UBS Warburg's existing \$15 million term loan to MedCenterDirect.Com, Inc. Healthcare Corporate Finance Department is requesting approval of a \$20 million (a \$5 million upsizing) 12-month term loan facility. HealthSouth Corporation, which owns 23% of MedCenterDirect, will continue to guarantee 100% of the MedCenterDirect loan. In order to make this loan a credit neutral event for UBSW, HealthSouth has agreed to offset the MedCenterDirect loan against UBSW's commitment to the proposed HealthSouth \$1.25 billion 5-year revolving credit facility.

HealthSouth is the largest provider of rehabilitative healthcare, outpatient surgery and outpatient services in the United States. The company delivers its services through a national network of more than 1,900 locations in all 50 states, Puerto Rico, the United Kingdom, Canada and Australia. In fiscal year 2001, HealthSouth generated total revenues of \$4,380.5 million and EBITDA of \$1,127.0 million after minority interest. HealthSouth currently carries \$3.0 billion of debt, with senior unsecured ratings of Ba1/BB-

MedCenterDirect was founded in 1999 (backed by HealthSouth) to develop an online marketplace for hospitals and alternate sites to purchase medical supplies from manufacturers. MedCenterDirect provides an e-procurement solution to healthcare providers for ordering inventory. The Company's software solution is designed to reduce administrative costs, improve inventory turns and ensure purchasing contract compliance. The Company currently provides its e-procurement purchasing solution to approximately 1,700 HealthSouth facilities. MedCenterDirect's only customer is HealthSouth.

**DECISION:** Approved

The committee approved the transaction as presented.

Chris Ryan instructed the deal team to push hard to obtain Sole-Books on the upcoming \$500 million senior notes issuance for HealthSouth.

**MATERIAL  
REDACTED**

CRC assigned an internal credit rating of C6 and approved a final hold of \$20 million.

BRG approved an unlimited make-whole payment based on an estimate of \$0.5 million on 27 March 2002.

Chris Ryan instructed Loan Syndication to manage down the overall HealthSouth exposure to \$100 to \$75 million over time through secondary sales or hedging.

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 UBS Warburg  
 COMMITTEE MINUTES

Tab 17

		Attendees	Attendees by Phone
Name	HEALTHSOUTH	Mark Connelly	Jack Shannon
Date	05/06/02	Donal Orr	Michelle Bereaux
Size	\$77.2 Million Block Trade	Doug Fawell	
Shares	5.7 Million Shares	Brad Miller	Bill McGahan
Timing		Bill Dowson	Rod O'Neill
Filing	TBA	Jesse Mark	Scott Wollard
Pricing	TBA	Kelly Shen	Michael Farah
UBS Role	Sole Bookrunner	Nick Pepe	Marshall Hyzdu
Managers		Mark Altman	
Book	UBS Warburg		
Co-Manager	NA		
Gross Spread	TBA		
Economics	100 (UBSW)		
Research	Howard Capek		

**Company Overview:**

HEALTHSOUTH (NYSE: HRC, \$6.2 billion equity market capitalization) is the nation's largest provider of outpatient surgery, outpatient diagnostic and rehabilitative healthcare services. The company provides these services through a national network of inpatient and outpatient healthcare facilities, including inpatient and outpatient rehabilitation facilities, outpatient surgery centers, diagnostic centers, medical centers and other healthcare facilities. As of March 31, 2002, HEALTHSOUTH operated approximately 1,900 locations in all 50 states, Puerto Rico, the United Kingdom, Canada and Australia. During fiscal 2001, HRC generated \$4.4 billion in revenues with \$1.1 billion in EBITDA after minority interests. LTM 3/31/02 revenue and EBITDA after minority interest were \$4,420 million and \$1,155 million respectively. In addition, the Company's inpatient rehabilitation services accounted for approximately 40% of revenues in 2001.

**Transaction Overview:**

Richard Scrusby, the Company's CEO, is looking to sell 5.2 million shares in a block trade. Currently, Mr. Scrusby owns 20.9 million shares (which includes 15.7 million options exercisable) or 5.3% of HRC's total shares outstanding. Following the block trade, Mr. Scrusby will own 15.7 million shares or 4.0% of the total shares outstanding including his options exercisable. The Company and UBS Warburg intend to launch the transaction within 14 days after May 7, 2002. The gross spread on the transaction is still to be determined. Assuming a closing price of \$14.85 on 5/3/02, the offering size will be approximately \$77.2 million.

**Issues:**

The Company is one of our best Healthcare clients. In the last 9 years, we have done 60 transactions with them.

These shares are not off the shelf, so they must be 144 shares.

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UBS/C 113054

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 **UBS Warburg**  
COMMITTEE MINUTES

Rod should speak with Ben Lorello on whether Ben thinks this deal should be done. Bill McGahan want to do the deal.

The trading desk will not make any money unless the bid is at least 6%. IBD gave the Company a bid of 4-6% discount.

It was questioned whether there is a \$8 for these options? IBD does not know.

The CEO is exercising his options at \$5.20.

The window for this is next Tuesday. There will be a call tomorrow morning with the Company concerning the discount.

It was suggested that there should be a press release.

Bill Schneider is aware of the transaction.

Approval:	Not approved. Subject to further discussions
Author:	Kelly Shen

Attendees:

Committee Members: Ed Massaro (Chairman), David Juge (Loan Syndication), David Bawden (CRC), Alex Geier (for Steve Ruggiero), Oliver Trumbo (Counsel), Joel Aresco (MRC) and Christian Rothardt (minutes)

Deal Team and others: Rod O'Neill (IBD), Scott Wollard (IBD), Michael Farah (IBD), Mike Newcomb (HYCM), CJ Corradino (Syndication), Andreas Wyier (CRC), David Goldman (CRC), Renata Jacobson (LPRM)

TRANSACTION: Healthsouth Corp.

Approval is sought to (i) commit \$120 million to a 5-year \$1.45 billion Senior Unsecured Revolving Credit Facility (the "Credit Facility") and (ii) to act as a bookrunner manager (on the left) on a 10-year NC, \$500 million Senior Unsecured Notes offering (the "Senior Notes") for HEALTHSOUTH Corporation ("HRC" or the "Company"). UBS Warburg will have a Co-Arranger and Co-Documentation Agent title in the Credit Facility equivalent to the \$200 million committing banks including JPMorgan Chase (Joint Lead Arranger), Wachovia (Joint Lead Arranger), Deutsche Bank, Banc of America, and Scotia Capital. UBS Warburg will be a Tri-Bookrunner on the Senior Notes to the left of Deutsche Bank and Banc of America. UBS Warburg expects to earn approximately \$900,000 in bank fees and \$1.2 million in bond fees for \$2.1 million in total fees. HEALTHSOUTH's credit rating is Ba1/BBB- with a stable outlook.

The top 6 Arranging banks in the Credit Facility are each asked to commit \$200 million by May 10, 2002. UBS Warburg's commitment is \$120 million due to our related HRC exposure in the First Cambridge 364-day credit facility and MedcenterDirect's twelve month loan. The bank meeting is on May 22nd and the closing is on June 13th. Proceeds from the Credit Facility will be used to refinance the existing \$1.75 billion revolver (currently \$540 million) due June 2003, the \$187 million Tax Retention Operating Leases ("TROs"), and the digital hospital lease financing (8.7 million).

The Senior Notes offering will be announced the week of May 16th and price May 23rd. Proceeds from the Senior Notes issue will be used to refinance the existing \$567.7 million 3.25% Convertible Subordinate Notes due April 2003.

DECISION: Approved

The committee approved the transaction as presented.

CRC approved a final hold of \$50 million (to be achieved within a 6-month period) and assigned an internal credit rating of C6.

MRC approved the transaction.

BRG approved an unlimited make whole payment based on an estimate from Loan Syndications of \$5 million pa.

The transaction requires approval from the GSFCC Ratification Committee.

=====  
GSFCC Ratification Committee Meeting on 8 May 2002:  
Mike Hutchins approved the transaction as presented.

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Equity Capital Markets


**UBS Warburg**  
 COMMITTEE MINUTES

Tab 19

		Attendees	Attendees by Phone
Name	HEALTHSOUTH	Mark Connelly	Dan Corkery
Date	05/13/02	Donal Orr	Julio Mojica
Size	\$77.2 Million Block Trade	Doug Fewell	Nick Pepe
Shares	-5.2 Million Shares	Bill Dowson	Michelle Bereaux
Timing		Jesse Mark	Bill Schneider
Filing	TBA	Kelly Shen	Justin Dwyer
Pricing	TBA		Andy Tuzhill
UBS Role	Sole Bookrunner	Mark Altman	Annette Spencer
Managers			
Book	UBS Warburg		Bill Mc Gahan
Co-Manager	NA		Rod O'Neill
Gross Spread	TBA		
Economics	100 (UBSW)		
Research	Howard Capek		

**Company Overview:**

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**Transaction Overview:**

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**Issues:**

The CEO's options will expire soon.

He can now exercise it because earnings were announced last week. The last time he sold was 4 years ago.

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**UBS Warburg**  
 COMMITTEE MINUTES

Ben Lorello has approved the transaction.

We are hoping to do a \$500-600M sole book convert for the company in the future.

The stock closed at \$14.45. In the after-market, at 4:17PM, the stock was at \$14.39.

Nick Pepe believes that the discount is awful, and that there is only opportunity to lose here. Nick is not enthusiastic about the trade. The good thing is that it is less than 3 days of trading volume. The negative aspect is that the market is sloppy and will be going into the next few weeks. As well, no one is happy about the last block trade we did, PDX.

Bill McGahan commented that if we don't put this deal up, Salomon Smith Barney will.

The Company is willing to send out a press release.

The option exercise program is at Salomon.

The Company (erroneously) thinks that the last trade is \$14.40, and with a 2.5% discount, we would be buying this at \$14.05.

It was questioned whether we can buy this at \$14.05, re-offer it at \$14.05, and get 5 cents from the buyer as commission.

It was noted that the CEO does not need to sell all his shares. He can just exercise all his options, and just sell enough to cover the cost of exercising.

**HOWARD WAS THEN BROUGHT OVER THE WALL**

Howard questioned whether the CEO was borrowing money from the Company to buy these shares, as he did last time. The answer was no. He is actually do this cashless using the proceeds of this offering, and as well paying back the Company using the rest of the proceeds.

Howard pointed out that with the recent volatility in the market, healthcare has become somewhat of a safe haven. Howard noted that HEALTHSOUTH is currently at a discount to the hospital comps. The Company has had a very healthy earnings release.

It was questioned whether it will be a problem doing this block tomorrow morning with the conference happening as well. It was noted that this is better so that the CEO can tell everyone that this is happening.

Since he needs to exercise his options, it was questioned how quickly the transfer agent can process this. As well, it was questioned how the option program is set up.

Bill McGahan noted that we will buy this at \$14.04 or \$14.05 and re-offer is at \$14.10, or \$14.05 with a \$0.05 commission.

Approval:	Yes
Author:	Kelly Shen

O'Neill, Roderick+

Tab 20

From: O'Neill, Roderick+  
 Sent: Tuesday, August 13, 2002 11:32 AM  
 To: 'bill.owens@healthsouth.com'; 'weston.smith@healthsouth.com';  
 'tadd.mcvay@healthsouth.com'; 'bill.horton@healthsouth.com'; 'rs.davis@healthsouth.com';  
 McGahan, William+; Ohare, Hugh+; Meisner, Joseph+; Wollard, Scott+; Farah, Michael;  
 Timmerman, William+; Leder, Michael+; Chia, Loy+; 'jason.brown@healthsouth.com'  
 Subject: FW:

In preparation for our Thursday call at 2:00 eastern, McGahan wanted to send out a summary of the work plan and responsibilities:

- 1) Additional financial / operational info on Diagnostic imaging: Weston Smith and Jason Brown
- 2) Detailed financials for Surgery Centers: Weston Smith
- 3) Model of HRC with sale and spin for banks and agencies: Hugh O'Hare
- 4) Bond Covenants / repurchase strategy / tender cost analysis / rating agency / surgery financing: Mike Leder and Tadd McVay
- 5) Tax opinions: Bill Horton and accountants
- 6) Press release / draft of Form 10: Bill Horton
- 7) Anticipated questions / written script: Rod O'Neill (first draft)
- 8) Shared services: Bill Owens
- 9) Diagnostic Offerring Memorandum / buyers list / confidentiality agreements: Rod O'Neill
- 10) Surgery audited financial info: Weston Smith
- 11) Working Group List: Scott Wollard

3 wks  
4-6 months

Sam  
Tom

TWAVENT @  
S MCBAR @KPMG

- ① Am Surg #1s  
Surgery
- ② Imjmg  
6 month press  
Tom Carmen  
Will not  
have proceeds  
immediately
- ③ Met  
Tessie  
Announcement
- ④ Change in  
group therapy  
effective July 1st

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BY UBS

UBS/C 070094

Neill, Roderick+

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**From:** O'Neill, Roderick+  
**Sent:** Tuesday, August 13, 2002 11:32 AM  
**To:** 'bill.owens@healthsouth.com'; 'weston.smith@healthsouth.com';  
'tadd.mcvay@healthsouth.com'; 'bill.horton@healthsouth.com'; 'rs.davis@healthsouth.com';  
McGahan, William+; Ohare, Hugh+; Meisner, Joseph+; Wollard, Scott+; Farah, Michael;  
Timmerman, William+; Leder, Michael+; Chia, Loy+; 'jason.brown@healthsouth.com'  
**Subject:** FW:

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- 9) Diagnostic Offerring Memorandum / buyers list / confidentiality agreements: Rod O'Neill
- 10) Surgery audited financial info: Weston Smith
- 11) Working Group List: Scott Wollard

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News From

FOR IMMEDIATE RELEASE  
August 27, 2002

**HEALTHSOUTH ANNOUNCES SEVERAL NEW DEVELOPMENTS:**

- Proposed Separation Of Surgery Center Division Into New Public Company
- Changes In Senior Management
- Impact Of Changes In Outpatient Therapy Reimbursement

BIRMINGHAM, Alabama – HEALTHSOUTH Corporation (NYSE: HRC) announced that its Board of Directors had approved in principle a plan to effect a tax-free separation of its surgery center division into a new publicly traded company, which would be the largest independent operator of freestanding outpatient surgery centers in the United States. The Board of Directors has authorized HEALTHSOUTH's management to proceed with development and implementation of the plan, subject to the satisfaction of certain conditions. If consummated, the plan will result in the issuance of shares in the new surgery center company to HEALTHSOUTH stockholders on a tax-free basis. HEALTHSOUTH believes that the new surgery center company would have improved access to the capital markets in order to take advantage of growth opportunities, and would enjoy competitive advantages not available to it as part of HEALTHSOUTH's existing network of facilities. The company also indicated that the separation would allow the surgery center business to grow without concerns relating to recent adverse developments in reimbursement for the company's outpatient rehabilitation operations, which are discussed below.

If the proposed plan is implemented, HEALTHSOUTH will continue to operate the largest network of inpatient and outpatient rehabilitation facilities in the United States, with facilities in all 50 states and overseas. HEALTHSOUTH's operations will include approximately 1,427 outpatient rehabilitation centers and 118 inpatient rehabilitation facilities, as well as four medical centers and 136 outpatient diagnostic centers. The new surgery center company will be the largest operator of freestanding outpatient surgery centers in the United States, with 209 facilities in 37 states. It is currently expected that the new company will operate under the name "Surgical Care Affiliates". Additional details about the proposed transaction and the expected management of the two companies are provided below.

The company indicated that it was moving forward with the separation plan at this time in part because of unfavorable developments in reimbursement for therapy services in its outpatient rehabilitation centers. Effective July 1, the Centers for Medicare and Medicaid Services ("CMS") issued a directive to Medicare Part B carriers requiring that outpatient therapy services provided to two or more patients in a single time period be paid for under the "group therapy" payment code, regardless of whether such patients were engaged in the same activity. This directive, which significantly lowers reimbursement for services previously paid as individual therapy, is

inconsistent with many providers' understanding of appropriate coding practice, which looks to the nature of the services provided and the clinical judgment of the therapist to determine whether the group code or individual codes are appropriate. Because this directive was not issued to providers or to Medicare Part A intermediaries, who administer payments under Part B to rehabilitation agencies such as those typically operated by HEALTHSOUTH, and because it appears to conflict with other statements by CMS and practices followed in the therapy industry, there has been substantial confusion regarding the impact and applicability of the directive. HEALTHSOUTH sought clarification through several meetings with its national Medicare intermediary and CMS officials in July and August and continued to receive somewhat conflicting guidance. However, pending further clarification, the company has begun implementation of policies and procedures designed to reflect a conservative interpretation of current Medicare coding requirements in light of the recent directive. Management believes that, over time, it will be able to adjust scheduling and staffing patterns to reduce the negative impact of this new interpretation. However, compliance with the conservative policies will adversely impact its revenues from outpatient rehabilitation services in the near term. The impact is expected to be particularly significant with respect to outpatient services provided through HEALTHSOUTH's inpatient rehabilitation operations, which have a substantially higher Medicare population than the outpatient centers operated through HEALTHSOUTH's Ambulatory Services division. The company believes that this Medicare policy interpretation may also affect reimbursement from private payors who utilize the Medicare outpatient therapy fee schedule and coding policies in establishing payment policies and rates.

As part of its preliminary 2003 budgeting process, HEALTHSOUTH is evaluating the potential negative impact of the new Medicare group therapy directive in the context of its overall business model for its outpatient rehabilitation operations. While the final impact of these reimbursement developments cannot be determined with certainty, and while HEALTHSOUTH expects to explore operational changes intended to mitigate their effects, the company currently believes that the impact of this reimbursement change will require material revisions to its business model and operating strategy in outpatient rehabilitation. In light of this assessment, and based on available information, the company currently believes that its revenues will be lower than previously projected by approximately \$175 million annually. Because of the uncertainties surrounding the full impact of these developments at this time, this initial assessment may prove incorrect, and the company is accordingly discontinuing earnings guidance for the remainder of 2002 and 2003 at this time.

"In light of the issues relating to outpatient rehabilitation revenue in the near term and the growth opportunities that we believe are out there for a pure-play surgery center company, we believe the time is right to allow the surgery center business to grow on its own, removed from the pressure of Medicare uncertainties in other parts of our business," said Richard M. Scrusby, Chairman of the Board and Chief Executive Officer of HEALTHSOUTH. "With an estimated \$1.1 billion in revenues, the new surgery center company should have ready access to the equity and debt markets, and we expect that it will be able to take advantage of partnership opportunities with physicians who recognize the high-quality, cost-efficient services provided by our surgery centers but who have perhaps been reluctant to join us because of their relationships with competitors in our other lines of business. At the same time, we believe that the strong cash flow provided by our successful response to the new inpatient rehabilitation prospective payment system and the unmatched geographic scope of our network will allow HEALTHSOUTH to continue setting the standard for care in inpatient and outpatient rehabilitation and to reduce our debt load, even while we adjust to recent unfavorable developments in our outpatient operations. While we make the necessary changes to our outpatient rehabilitation strategy, we will also be exploring potential

divestitures of non-core assets and businesses, allowing our management team to continue to grow and improve our rehabilitation operations and providing additional cash to strengthen our balance sheet.”

Mr. Scrusby will serve as Chairman of the Board of the new surgery center company, and will actively work with the management team in the development and formation of the new company. In order to allow the time to focus on these activities, Mr. Scrusby will turn over day-to-day management of HEALTHSOUTH to William T. Owens, President and Chief Operating Officer, who will assume the position of Chief Executive Officer effectively immediately. Mr. Scrusby will continue to lead HEALTHSOUTH as Chairman of the Board and work with Mr. Owens and the rest of the management team as they re-design HEALTHSOUTH's operations to meet the new challenges faced by the company.

“The Board and I have chosen Bill Owens as my successor as CEO because of his experience and leadership,” said Scrusby. “As someone who has been intimately involved in all aspects of our business since 1986, Bill has had excellent training for the job while serving as Controller, CFO and COO. I have great confidence in his ability to lead HEALTHSOUTH as CEO.”

The company announced several other management changes in connection with the proposed transaction. In order to ensure that the proposed transaction is implemented as quickly and smoothly as practicable, Weston L. Smith, currently Executive Vice President and Chief Financial Officer of HEALTHSOUTH, will immediately assume full-time responsibility for implementing the proposed separation transaction, with full oversight of all financial, tax and regulatory aspects of the plan. Upon completion of the transaction, Mr. Smith will serve as Chief Financial Officer of the surgery center company. Malcolm E. “Tadd” McVay, currently HEALTHSOUTH's Executive Vice President and Treasurer, will become Chief Financial Officer of HEALTHSOUTH effective immediately, and Thomas W. Carman, Executive Vice President – Corporate Development, will serve as Chief Development Officer for HEALTHSOUTH.

Larry D. Taylor, currently President and Chief Operating Officer of HEALTHSOUTH's Ambulatory Services division, will become Chief Executive Officer of the new surgery center company after the transaction. Suzanne T. Henninger, currently Senior Vice President – Ambulatory Development, will serve as Chief Development Officer of the new company. Other management of the two companies will be drawn from the existing HEALTHSOUTH management team. The companies will have separate board of directors, which will include both existing HEALTHSOUTH directors and new candidates.

“We believe that we can put two of the strongest management teams in healthcare on the field in this transaction,” said Scrusby. “Larry Taylor has held almost every position possible in our ambulatory services business, and he is well-qualified to run a surgery center company that will continue to be the nation's leader. As Bill Owens takes over my CEO duties with HEALTHSOUTH, I will have time to help Larry develop a comprehensive strategic plan for the surgery center company and position it to succeed as a stand-alone public company. Further, by freeing up Weston Smith to focus full-time, daily attention on the process, we know that we can move this transaction forward efficiently without losing any focus on our day-to-day operations, and Tadd McVay is an experienced, capable Chief Financial Officer with a strong profile in the capital markets. We have top-flight, experienced teams with operational experience and Wall Street experience to support both companies, and I am excited that these key leaders will have the chance to take on new and challenging responsibilities.”

It is expected that the two companies will enter into an agreement to share various support services on arm's-length terms for a period of time. While proceeding with the technical and regulatory steps required to move forward with the separation plan, the company will evaluate appropriate corporate structures and functions and operational systems, as well as the impact of the proposed transaction on the company's public and bank debt.

Biographical information on key members of the two management teams follows the text of this announcement.

The proposed separation transaction is contingent upon receipt of favorable opinions as to the tax-free nature of the transaction from HEALTHSOUTH's independent tax accountants and special tax counsel, as well as upon various other governmental and third-party approvals and customary conditions, including registration of the surgery center company's stock under the Securities Exchange Act of 1934. The transaction is also subject to final approval by HEALTHSOUTH's Board of Directors. The company currently expects to complete the transaction, subject to such conditions and approvals, by the first quarter of 2003.

HEALTHSOUTH is the nation's largest provider of outpatient surgery, diagnostic imaging and rehabilitative healthcare services, with approximately 1,900 locations in all 50 states, the United Kingdom, Australia, Puerto Rico and Canada. HEALTHSOUTH can be found on the Web at [www.healthsouth.com](http://www.healthsouth.com).

HEALTHSOUTH will hold a conference call to discuss this announcement at 9:30 a.m. Central Daylight Time on Tuesday, August 27. Interested persons may access the call by dialing 1-800-611-1147 and entering confirmation code 649866. Simultaneously with the conference call, a webcast of the call will be available at [www.healthsouth.com](http://www.healthsouth.com) via an Internet link under the "Investor Relations" section. A replay of the call will be available at the same Internet site address for 15 days following the call.

Statements contained in this press release which are not historical facts are forward-looking statements. Without limiting the generality of the preceding statement, all statements in this press release concerning or relating to estimated and projected revenues, earnings, margins, costs, expenditures, cash flows, growth rates and financial results, as well as to the consummation of the transactions described herein, are forward-looking statements. In addition, HEALTHSOUTH, through its senior management, may from time to time make forward-looking public statements concerning the matters described herein. Such forward-looking statements are necessarily estimates based upon current information, involve a number of risks and uncertainties and are made pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. HEALTHSOUTH's actual results may differ materially from the results anticipated in these forward-looking statements as a result of a variety of factors, including those identified in this press release and in the public filings made by HEALTHSOUTH with the Securities and Exchange Commission, including HEALTHSOUTH's Annual Report on Form 10-K for the year ended December 31, 2001 and its Quarterly Reports on Form 10-Q, and forward-looking statements contained in this press release or in other public statements of HEALTHSOUTH or its senior management should be considered in light of those factors. There can be no assurance that such factors or other factors will not affect the accuracy of such forward-looking statements.

#### Management Information

**Richard M. Scrushy (Chairman of the Board):** Richard M. Scrushy founded HEALTHSOUTH in January 1984 and has served as Chairman of the Board and Chief Executive Officer since that time, also serving as President from January 1994 until March 1995. Through his vision and energy, HEALTHSOUTH grew from a start-up idea to the nation's largest provider of outpatient surgery, diagnostic imaging and rehabilitative healthcare, with over \$4.3 billion in revenues in 2001. He has also been a founder of two other New York Stock Exchange-listed companies in the past ten years.

**William T. Owens (CEO, HEALTHSOUTH Corporation):** Bill Owens joined HEALTHSOUTH in March 1986 as Controller, when the company had \$4.5 million in revenues and \$12 million in assets. He served in that position as HEALTHSOUTH grew into a Fortune 500 company, and was named Executive Vice President and Chief Financial Officer in February 2000 and President and Chief Operating Officer in August 2001. He has served as a director of HEALTHSOUTH since March 2001. Mr. Owens is a certified public accountant, and he specialized in healthcare finance and auditing with Ernst & Young before joining HEALTHSOUTH.

**Malcolm E. McVay (CFO, HEALTHSOUTH Corporation):** Tadd McVay joined HEALTHSOUTH in September 1999 and was named Senior Vice President and Treasurer in February 2000 and Executive Vice President and Treasurer in August 2001. As Treasurer, Mr. McVay has played a major role in refinancing substantially all of HEALTHSOUTH's long-term debt over the past two years. A former commercial banker, Mr. McVay previously served as Chief Financial Officer of Capstone Capital Corporation (NYSE:CCT) and as Senior Vice President of Investor Relations at CaremarkRx, Inc. (NYSE:CMX).

**Thomas W. Carman (Chief Development Officer, HEALTHSOUTH Corporation):** Thom Carman joined HEALTHSOUTH as Director of Corporate Development in April 1985 and has served as Executive Vice President - Corporate Development since \_\_\_\_, with responsibility for acquisition, start-up and joint venture activities. Before joining HEALTHSOUTH, Mr. Carman had an extensive background in healthcare development and administration and health planning.

**Larry D. Taylor (CEO, Surgery Centers):** Larry Taylor joined HEALTHSOUTH in May 1987 as a facility administrator, and progressed through every management position in HEALTHSOUTH's outpatient operations, ultimately being named President and Chief Operating Officer of the Ambulatory Services Division in August 2001. In that position, Mr. Taylor has been responsible for the operations of outpatient facilities in all HEALTHSOUTH's lines of business in 50 states. In addition, he played a key role in the development of HEALTHSOUTH's outpatient outcomes tracking and sports medicine outreach programs.

**Weston L. Smith (CFO, Surgery Centers):** Weston Smith joined HEALTHSOUTH in February 1987 and led the company's reimbursement department until March 2000, when he became Senior Vice President and Controller. In August 2001, he was named Executive Vice President and Chief Financial Officer. A certified public accountant with Ernst & Young before joining HEALTHSOUTH, Mr. Smith has extensive experience in public company accounting, reimbursement and corporate finance.

**Suzanne T. Henninger (Chief Development Officer, Surgery Centers):** Suzanne Henninger joined HEALTHSOUTH in \_\_\_\_ 1984 and assumed increasing responsibility for outpatient development activities, becoming Senior Vice President - Corporate Development in \_\_\_\_\_. In

that role, she was in charge of development and acquisition activities for all of the company's outpatient operations. After leaving the company in September 1999 to devote more time to family activities, she rejoined HEALTHSOUTH in November 2001 as Senior Vice President - Ambulatory Development.

####

*For more information, contact Richard M. Scrushy, Chairman of the Board, William T. Owens, President and CEO, or Tadd McVay, Executive Vice President and CFO, at 205-967-7116*

609

From: William.McGahan@ubsw.com  
To: Horton, Bill **Tab 22**  
Subject: RE: Surgery Center Transaction  
Date: 09/18/2002 12:41:45 AM EST

Ben has now explained to me its a strategy of "make up your mind now without any information and then we get to put your vote in a bucket and lock it down." It now makes perfect sense to me.

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: McGahan, William+ <William.McGahan@ubsw.com>  
To: 'Bill.Horton@healthsouth.com' <Bill.Horton@healthsouth.com>  
Sent: Wed Sep 18 00:34:01 2002  
Subject: RE: Surgery Center Transaction

Owens and I left them alone together. That was our big mistake. I came back into the room and they were all set to tender for the shares that afternoon and to put out a press release immediately. I say we stick to the original plan of a traditional split-off. Call me. Bill

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: Horton, Bill <Bill.Horton@healthsouth.com>  
To: McGahan, William+ <William.McGahan@ubsw.com>  
Sent: Wed Sep 18 00:07:39 2002  
Subject: RE: Surgery Center Transaction

Will do. You realize, of course, that he's offered a taste of whatever he was on to someone who has an addictive personality.

-----Original Message-----  
From: William.McGahan@ubsw.com [mailto:William.McGahan@ubsw.com]  
Sent: Tuesday, September 17, 2002 11:07 PM  
To: Horton, Bill  
Subject: Re: Surgery Center Transaction

Call me tomorrow. I think Ben was on a little drugs. Bill  
-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: Horton, Bill <Bill.Horton@healthsouth.com>  
To: McGahan, William+ <William.McGahan@ubsw.com>  
Sent: Tue Sep 17 23:37:58 2002

Subject: Surgery Center Transaction

I am not immediately having luck finding the deal that you referred me to in my SEC filing sources. I don't understand what you guys have described to Richard. Can you get someone to either send me the relevant filings or direct me to an online link for them? Thanks.

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## UBSW Email

From: White, Heather+  
 Sent: Wednesday, November 27, 2002 4:32 PM  
 To: Lorelio, Benjamin+; McGahan, William+  
 Cc: Lantz, Terry+; Richtt, Nicholas+  
 Subject: FW: Expense Reimbursements



HC.xls

Tab 23

Please see the attached.

-----Original Message-----

From: Mittman, Dan+  
 Sent: Wednesday, November 27, 2002 4:24 PM  
 To: Effron, Blair+; McCarthy, Kevin-S+; Martin, Michael-E+; Lorelio, Benjamin+; McGahan, William+; McDermott, Jeffrey+; Knight, Paul+; Sine, Jeff+; Hulse, Walter+; Brooks, Leonard+; Hsieh, Jackson+; Benninger, Thomas+; Elmhirst, Jake+; Newmark, Evan+; Terry, Davis+; Ryan, James+  
 Cc: Ellis, Noreen+; Boynton, Brett+; Greenwood, Edith+; Lantz, Terry+; Richtt, Nicholas+; Harris, Karen-B+; Arias, Julian+; Maclusi, Nickie+; Williams, Victoria+; Gilchrist, Carolyn+; Hughes, Tim+; Rivera, Rosalie+; Lewis, James+; Le-Roux, Kim+; Crain, Elizabeth+; Leaman, Rick+; Neissa, James+; Mittman, Dan+; White, Heather+  
 Subject: Expense Reimbursements

In connection with the year-end push to hit 2002 targets, Rick Leaman and Jimmy Neissa have asked Heather White to circulate a list of active engagements to each Sector, so that your groups can seek reimbursement of outstanding out-of-pocket expenses. As you are aware, our standard engagement letters provide for our clients to reimburse UBS "upon request." UBS has signed engagements for those transactions on the list with a 25% or greater probability. You assistants or Business Managers will be able to do the appropriate expense runs.

Please make every effort to collect on these outstanding expenses before the end of the year.

Thanks.

Dan

-----Original Message-----

From: Reeve, Nadine+ <Nadine.Reeve@ubsw.com>  
 Sent: Wed Nov 27 12:45:44 2002  
 Subject: Message from R Gillespie, R Tapner & K Moelis: Additional Revenue Targets

The annual revenue chase for the final push to achieve our 2002 target is now well under way and responses this year have been much more encouraging than in previous years. Additionally the fall-out of existing pipeline revenue has been less than in previous years. This increases the pressure on those who have not yet responded to the email requesting that you each identify US\$1 m 'of incremental revenue' to be billed prior to year-end. This, by definition means, revenue which is not currently in our waited pipeline.

To date you have not responded to our earlier email and we would be grateful if you could do so by no later than 2nd December with your suggestions as to how you will achieve the US\$1 m target.

Please copy your responses to Paul Tame.

Many thanks.

1

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 BY UBS

UBS/C 095595

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**Healthcare**

<u>Client/ Project Name</u>	<u>BRG Date</u>	<u>Sector</u>	<u>Transaction Description</u>	<u>MD</u>
			Non-HealthSouth Confidential UBS Client Information Redacted	
Caremark Rx, Inc. (P. Cougar)	6/25/2002	HealthCare	Buy Side	Leaman

Non-HealthSouth  
Confidential UBS Client  
Information Redacted

HEALTHSOUTH (P. Crimson)	8/13/2002	HealthCare	Sell Side	Leaman, O'Hare
--------------------------	-----------	------------	-----------	----------------

Non-HealthSouth  
Confidential UBS Client  
Information Redacted

Integrated Health Services		HealthCare	Advisory	Leaman
Integrated Health Services		HealthCare	Restructuring	Leaman

**UBS/C 095597**

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BY UBS**

MINUTES of the GSF Commitments Committee Meeting  
23 December 2002

Attendees:

Committee Members: Chris Ryan (Chairman), David Bawden (CRC), Annette Spencer (Committee Counsel),  
Carel van Randwyck (minutes)

Deal Team and others: Mike Leder (IBD), Rod O'Neill (IBD), Scott Wollard (IBD), CJ Corradino (Loan Syndicate),  
Gary Riddell (CRC), Andreas Wyler (CRC), Renata Jacobsen (LPRM).

TRANSACTION: Healthcare Capital Investors SPV

DECISION: Approved (initially Deferred)

Approval is sought from the GSFCC for UBSW to extend the current 12-month, \$82.5 million loan to First Cambridge HCI Acq. LLC by four business days from 26 December 2002 to 2 January 2003, in the context of an overall desire by the company to obtain a 90-day extension for the loan.

The Committee deferred the request subject to:

- Opinion from Compliance on the proposed transaction
- Ratification from senior management

First Cambridge HCI Acq. LLC is a special purpose entity created by Healthcare Capital Investors (HCI), a real estate investment trust and a division of Cambridge Holdings inc., a subsidiary of Healthsouth.

CRC agreed with the four-day extension and expressed concerns with the fact that the loan guarantee had not been reported and the associated potential reputational risk to UBSW.

The loan was used to enable the SPV to acquire property assets from Healthsouth. However, this loan was not secured by Healthsouth by a mortgage over the properties. The company is currently looking for a 90-day extension for the loan, thereby obtaining sufficient time to obtain security over these assets.

The Deal Team were invited to obtain BRG approval for the proposed transaction.

The current facility includes a Keepwell Agreement, in the form of a side letter, guaranteeing this loan to UBSW. The company's auditors did not disclose this guarantee in the company's last reported audited financial statements.

In the event that this loan is extended beyond 2 January, we will require cash from the company as collateral for the loan.

Healthsouth has received an LOI for the purchase of these properties. However, the company is seeking security over these assets in the event the sale does not proceed.

The Chairman queried if the company had considered issuing an L/C in lieu of cash collateral for the loan – according to the Deal Team, they had not. Legal did not support making this suggestion to the client.

The company is being closely scrutinised, amid accusations that it failed to disclose the potential financial impact on the business from proposed regulatory changes.

Following discussions and e-mail exchanges between the client's in-house counsel, Legal, CRC, the Healthsouth Client Relationship Director, the Deal Team and the GSFCC Chairman, the latter obtained comfort that:

- Should the company provide cash collateral for the loan, this would be reported as a footnote in the company's 10K filing
- The extension is only to obtain additional time to arrange security interests over the First Cambridge property which would be necessary for any further extension of the HRC guarantee and the UBS loan, and
- That HRC has been trying to show a consistent debt reduction to their credit facility lenders, consistent with their bank deal covenants and that HRC considers a posting of the cash collateral in conjunction with an arrangement for the granting of security interests in the property is the debt reduction picture HRC wants to present to its lenders.

Country: MEMPHIS

Contract:  UHS Protocol  FJ

Legal:  Direct Ref:  RXMP

Portfolio: MEMPH Country (LA): \_\_\_\_\_

Initials: AW Date: 01.03.2003

Privileged Material  
Redacted

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REQUESTED BY UBS

UBS/C 217718

 UBS Warburg

Privileged Material  
Redacted

page 2 of 2

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

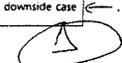
UBS/C 217719

 <span style="float: right;">Credit Risk Control</span>																																																																																																													
Counterparty Name	Source Medical Solutions Inc																																																																																																												
RMM	TBA																																																																																																												
Review Purpose	Credit Proposal																																																																																																												
<b>Facilities</b>																																																																																																													
<b>Banking Products</b>	Establish a new \$22.0mm 10 month senior secured multiple draw term loan credit facility maturing January 15 <sup>th</sup> 2004. The facility is secured by all assets of the borrower and all other debt will be subordinated to this facility. The facility is fully guaranteed by Healthsouth Corporation. Cross default into the Medcenterdirect.com 1 Year term loan facility maturing March 31 <sup>st</sup> 2003.																																																																																																												
	<table border="1"> <thead> <tr> <th>Draw Schedule</th> <th>Draw Periods</th> <th>Draw Amount (\$mm)</th> </tr> </thead> <tbody> <tr> <td></td> <td>February 28 through March 31, 2003</td> <td>\$5.00</td> </tr> <tr> <td></td> <td>April 1 through June 30, 2003</td> <td>\$5.70</td> </tr> <tr> <td></td> <td>July 1 through September 30, 2003</td> <td>\$5.70</td> </tr> <tr> <td></td> <td>October 1 through December 31, 2003</td> <td>\$5.60</td> </tr> <tr> <td></td> <td><b>Total</b></td> <td><b>\$22.00</b></td> </tr> </tbody> </table>	Draw Schedule	Draw Periods	Draw Amount (\$mm)		February 28 through March 31, 2003	\$5.00		April 1 through June 30, 2003	\$5.70		July 1 through September 30, 2003	\$5.70		October 1 through December 31, 2003	\$5.60		<b>Total</b>	<b>\$22.00</b>																																																																																										
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<b>Key Covenants</b>	<p>Covenants are set as per Healthsouth's \$1.25 bln 5 Yr RCF.</p> <ol style="list-style-type: none"> <li>Interest Expense / EBITDA Ratio: Not less than 2.5 : 1.0</li> <li>Total Debt / EBITDA Ratio : Not to Exceed 3.5 : 1.0</li> </ol> <p>As at September 30<sup>th</sup> 2002 HRC reported coverage ratio's of 5.28x interest coverage, and 2.97x total debt.</p>																																																																																																												
<b>Facility usage</b>	To refinance maturing debt and for working capital/general corporate purposes																																																																																																												
<b>GSFCC</b>	<p>GSFCC deferred its decision for approval to the UBSW management committee. The decision reflects the expectation that UBS is looking at the guarantee (Healthsouth) for repayment. Certain Healthsouth executives are currently under formal SEC investigation and FBI investigation for insider dealing. The justice department has also filed a civil lawsuit against Healthsouth Corp alleging the company defrauded Medicare for physical-therapy services by its outpatient clinics. CRC indicated that we were not looking to increase exposure to Healthsouth due to increased reputational risk profile. <i>The refinancing is</i></p>																																																																																																												
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<b>CRC Authority</b>	Deputy CEO - David Bawden																																																																																																												
<b>CRC Recommendation</b>	<p>CRC NA Corporates does not support the proposed transaction for source Medical based on the fact that Healthsouth remains our only source of repayment. Healthsouth and certain executives including CEO, Richard Scrusby remain subject numerous SEC and FBI investigations into insider dealing, loss of management credibility, increased reputational risk. The timing of the deal is also unfavourable as we await reported Q4 and year end figures (published March 3<sup>rd</sup>). The figures will be the first full indication of the effects of Medicare reimbursement policies on Healthsouth's EBITDA. At present we can only follow management guidance and street estimates. According to IBD - CRC downside case the leverage (TD / EBITDA) ratio will be breached.</p>																																																																																																												

Tab 25

*Negative*

*held out the asset amount product at the time*



**Source Medical Solutions Inc**

**Summary**

Source Medical Solutions Inc is a leading provider of outpatient healthcare information solutions with projected 2002 revenue of \$27.6 million and a backlog of \$134 million from subscription based contracts. The Company is projected to operate at breakeven in 4Q2003 according to management guidance. Products offered include a modular, pre-packaged suite of proprietary software applications that captures, automates and integrates key administrative, clinical and financial data to enhance the patient care and practice management processes. The Company's suite of software applications includes the following modules: 1) Administrative Module, which automates scheduling, registration, and collection of demographic and insurance information; 2) Clinical Documentation Module, which automates clinical documentation and coding; and 3) Financial Module, which automates billing and collection, and inventory and financial management.

*Trans?* →

To date Source Medical Solutions Inc has over 3,500 sites installed across all 50 states, Guam, Mexico and Canada. Source Medical is the nation's largest and most diverse IT solutions provider for the outpatient healthcare market. Clients include some of the largest providers of outpatient care services, such as HCA, Tenet, HEALTHSOUTH, Radiology, United Surgical Partners, National Surgical Hospitals, Johnson & Johnson and Symbion.

Source Medical Solutions Inc is owned by HEALTHSOUTH CORP 30% (3.9mm shares), Source Medical management 24% (3.2mm shares), and other individuals 46% (6.0mm shares). Included in other individuals are Richard Scruschy and Bill Owens, who own 15.5% (2mm shares) of the company. Source Medical management has indicated that both Scruschy and Owens will donate their shares to charity. In addition, the 14 other individual HRC owners are either giving their shares to charity or selling the shares back to Source Medical at cost (\$0.10 per share). HEALTHSOUTH will continue to hold their 30%.

(\$mm)	Actual
Cash and Equivalents	\$1.50
Long Term Debt and Leases <sup>1</sup>	84.7
Shareholders' Equity	0.3
Total Capitalization	\$85.00
Debt / Total Capitalization	99.70%

SOURCE: Source Medical Solutions Inc management

**Financials**

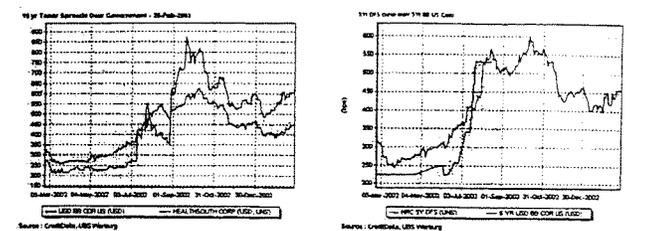
FYE December 31,	2001	2002P	Q1 03	Q2 03	Q3 03	Q4 03	2003P	2004P
Total revenue (\$000s)	9,852	27,657	9,023	11,513	12,645	14,197	47,378	77,893
EBITDA (ex R&D)	313	-5,971	na	na	na	na	6,271	158,883
EBITDA (inc R&D)	-5,564	-14,295	-3,404	-1,619	-1,112	333	-5,802	15,888
Net income (inc R&D)	-8,052	-19,478	-4,754	-2,969	-2,462	-1,017	-11,202	9,650

SOURCE: Source Medical management

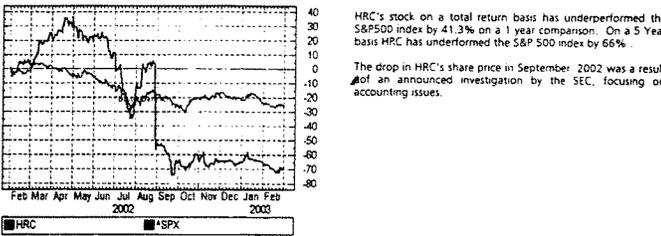
NOTES:  
 1. Includes six months of TherapySource and nine months of SurgiSource operating performance  
 2. Includes nine months of Advantix Practice & Advantix Surgery Center actual & projected operating performance; includes four months of ReadyView actual & projected operating performance  
 3. In 2004, will expense all R&D resulting in EBITDA, before & after R&D, being the same

Source Medical's current cash burn is approximately \$1.5 million per month, or \$18 million per year. Given this current cash burn rate, the proceeds from this credit facility should provide Source Medical with enough cash to last approximately 12 months after paying off the Company's existing bank debt.

<b>Healthsouth Corp</b>					
<b>Ratings</b>					
S&P	BBB / -ve watch	Moodys	Baa3 (stable)	KMV	EDF 6.93 (DO)
UBSW Eq. Research	Rated 'Buy2' @ Jan 11 <sup>th</sup> 2003 with a price target of \$8.00 (Current: \$3.62) - Analyst: Howard Capek				
CRC	INW: C9	QLD: C9			

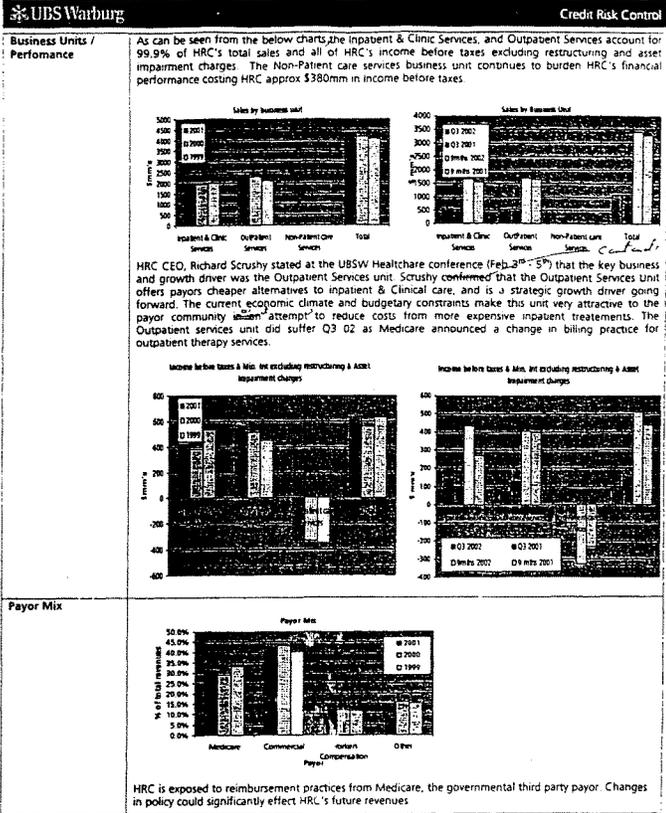


**Company Performance**



**Company Profile**

<b>Summary</b>	<p>HRC's principal activities include outpatient surgery, diagnostic and rehabilitative healthcare services through a network of outpatient and inpatient healthcare rehabilitation facilities. HRC operates with 3 reportable segments: Outpatient services, Inpatient and other clinical services, and, Non patient care services. The services are provided to patients, payors, physicians, case managers and other referral sources. Healthsouth has 120 inpatient rehabilitation facilities, 5 medical centers, 222 surgery centers, 142 diagnostic centers and provides outpatient rehabilitative healthcare services through 1407 outpatient locations. It operates in the United States, United Kingdom and Australia. Outpatient services accounted for 54% of 2001 revenues; inpatient and other clinical services, 46% and Non patient care services, nominal.</p>
----------------	--



* UBS Warburg		Credit Risk Control
<b>Management</b>	CEO and founder Richard Scrusby has been with HRC for 19 years and has been voted one of America's worst performing CEO's by Forbes magazine (Apr 02). Scrusby stepped down as CEO of HealthSouth to head a proposed surgery center spin-off company during August 02. The deal was scrapped after opposition from investors, some of whom called for Scrusby to leave the company. Scrusby was voted back as CEO during January 03. Certain individuals continue to be subject to SEC and FBI investigations for possible insider trading concerning the sale of stock options during August 2002. CRC maintains its negative view of management.	
<b>Company &amp; Industry News</b> <i>E (lead is issue note)</i>		
02/26/2003	HRC announced that the SEC investigation into certain executives insider dealing is made formal. The SEC investigation was previously announced 09/18/02.	
02/10/2003	It is reported that the criminal probe of HEALTHSOUTH Corp. could negatively affect the company's efforts to restructure its independent board. It is understood that the board's corporate-governance panel plans to appoint up to three new directors. One person familiar with the matter said the panel could have problems filling up the board slots "until the probe is resolved".	
02/06/2003	HRC announced that it had received a subpoena from the US Attorney's Office for the Northern District of Alabama seeking production of various documents in connection with an investigation. While the Company has not been advised of the nature or scope of the investigation, the types of documents requested suggest that the investigation may focus on transactions by individuals in HEALTHSOUTH common stock. Many of the documents requested have already been voluntarily provided by the company to the SEC. The company expects to fully cooperate with the investigation, as it has with the previous request from the SEC.	
02/03/2003	The CMS announced it will actively enforce the 75% rule for inpatient rehabilitation providers commencing 10/01/03. In order to bill Medicare under inpatient Rehab PPS an inpatient rehabilitation facility must "show that during its most recent 12 month cost reporting period, it served an inpatient population of whom at least 75% required intensive rehabilitative services for treatment of one or more of 10 pre-defined conditions. To date the CMS has not actively enforced this rule, and has confirmed that a number of providers bill Medicare under IRF's that do not meet requirements. HRC has provided guidance that 100% of its facilities meet the requirements and that it has not been contacted by the CMS on this issue.	
01/27/2003	HRC announced that its Board of Directors has adopted a new charter for its Nominating / Corporate Governance Committee designed to meet the requirements of the new standards as proposed by the NYSE. The new standards are in response to increased scrutiny <del>from the SEC</del> of recent investigations by the SEC on certain employee's sale of stock options.  Under the new charter, the Nominating/Corporate Governance Committee will: - Identify and evaluate potential candidates for the Board of Directors; - Recommend to the Board of Director nominees for election at each annual meeting of stockholders; - Develop and recommend to the board corporate governance principles and criteria for the selection of new directors and members of Board committees; and - Oversee the evaluation process of the Board of Directors and management.	
01/21/2003	A Delaware Chancery Court rejected HRC's bid to place investor lawsuits on hold. The lawsuits relate to the use of insider information by 3 executives and CEO Richard Scrusby, who sold \$106.7mm shares in August 2002. The judge questioned the independence and impartiality of a special committee put in place to investigate the said stock transactions by HRC. The lawsuits filed by investors contend that HRC executives sold shares before telling investors of that planned cuts in Medicare payments would reduce EBITDA by approx \$175mm. Investors believe that HRC knew by Mid 2002 of the proposed Governmental cuts to rehabilitation therapy rebates. In October 2002 an independent law firm (Fulbright & Jaworski) hired by HRC found that the persons involved had no knowledge of the changes or the potential effect on HRC profits.	
01/06/2003	HRC announced that it will make several changes in responsibilities among its senior management team. Effectively immediately, Richard M. Scrusby, Chairman of the Board of HRC, will resume his role as Chief Executive Officer, a position he held from the inception of the company until August 2002. William T. Owens, currently CEO, will resume his prior duties as CFO, and current CFO Malcolm E. McVay will undertake the role of Treasurer to the company. Operating division presidents Patrick A. Foster, Larry D. Taylor and Daniel J. Riviere will continue in those positions and will report directly to Mr. Scrusby.	
12/18/2002	HRC's Corporate Governance Committee announced it has engaged two independent search firms to identify and propose additional, independent members for HRC's board of directors. The engagement is a result of HRC's intension to improve the company's corporate governance structure.	

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Tab 26

February 26, 2003 Global Syndicated Finance  
Commitment Committee Meeting  
Concerning Proposed Loan to  
Source Medical Solutions, Inc.

1 bonds that mature before a revolver. Are  
2 you sure?

3 DAVID BAWDEN: I'm -- yeah, I'm -- I'm  
4 sure. What I'm looking at here is, I'm  
5 concerned about dealing with these  
6 entities, I don't think we've got full  
7 transparency on the -- on Source Medical.  
8 I don't like the fact that we've got  
9 management who have been owning shares and  
10 this, and now donating them to charities,  
11 and so forth. I wouldn't trust Scrushy,  
12 Rod, further than we can throw him. I  
13 don't think this company management has  
14 been that transparent with us the past.

15 CHRIS RYAN: But that's true with both  
16 entities.

17 DAVID BAWDEN: Yeah.

18 CHRIS RYAN: Right. So what -- I  
19 mean, I'm just -- why would you rather in  
20 '07 four years, than a '03 one year?

21 DAVID BAWDEN: (Inaudible) I'd rather  
22 (inaudible) be in '03 --

23 CHRIS RYAN: '04, one year, I guess.

24 DAVID BAWDEN: -- for one year at  
25 HealthSouth, than an '07 at HealthSouth --

1 I do not want to be lending to Source  
2 Medical Solution.  
3 SPEAKER: So, you know --  
4 SPEAKER: Please -- please, explain.  
5 I am confused. I don't understand -- you  
6 doubt the validity of the guaranty, is  
7 there a problem with it?  
8 DAVID BAWDEN: I'm not doubting the  
9 validity of the guaranty, I'm -- what I  
10 don't like is the reputation at issues  
11 that (inaudible) we're running with this  
12 -- with this entity. And I don't like the  
13 fact that we keep getting asked to deal  
14 with these partially owned companies, and  
15 a lot of it revolves around the -- just  
16 the noise that's going on with this  
17 company. I mean, you know, the fact is  
18 there's a SEC investigation, the FBI is in  
19 there. It just smells bad and --  
20 CHRIS RYAN: Okay. The -- the -- I  
21 think the firm -- well, we ought to check  
22 if the firm wants to have a relationship  
23 with the company, but -- and -- and that's  
24 that then. I think that's a fundamental  
25 issue. But if the firm -- let's just say

1 -- we've got a -- a manner of resolving  
2 that, which is not -- not me or this  
3 committee. And I think it can -- I agree  
4 with you, we should vet this before we  
5 lend anywhere money in, and -- and that  
6 this transaction, make sure that this is a  
7 client that we want to continue to -- to  
8 promote within the firm.

9 But if the firm decides to -- whoever  
10 that -- I'm not sure who that body is, but  
11 we'll collect it, you know, it's probably  
12 -- maybe it's management committee, let's  
13 say at Warburg. Let's say they decided  
14 they want to push on with HealthSouth, and  
15 therefore they want to try to accommodate  
16 the client where -- where we can, like we  
17 do our other clients.

18 DAVID BAWDEN: Chris, we're being  
19 asked to accommodate of client in a  
20 fashion that we typically do not, have not  
21 -- we do not get asked to accommodate  
22 other clients.

23 CHRIS RYAN: I disagree with that,  
24 David.

25 DAVID BAWDEN: Asked to provide

1 clients we -- we view as -- as key clients  
2 of the firm. And I'm --

3 DAVID BAWDEN: But (inaudible) we  
4 should only be doing it for companies with  
5 decent reputations, and this company's  
6 tarnished its reputation in just about  
7 every which way over the last year.

8 CHRIS RYAN: That's -- that's a fair --  
9 well, I think that's a fair comment, at  
10 least as near -- as near as I can tell.  
11 But I don't think it's -- certainly, it's  
12 not my call to --

13 DAVID BAWDEN: (Inaudible) but clearly  
14 the way.

15 CHRIS RYAN: -- turn this down on that  
16 basis.

17 DAVID BAWDEN: Yeah. Shares are  
18 traded the way market perceives this  
19 company. There's a negative sentiment  
20 toward it, and I don't think -- the market  
21 per se has particularly a -- a kind view  
22 of the company or the management.

23 CHRIS RYAN: Right. I mean that's --  
24 (Talking simultaneously.)

25 DAVID BAWDEN: The point -- the point

1 a straight comparison here, given the  
2 borrower and the circumstances.

3 CHRIS RYAN: Okay. Well, let -- let  
4 -- here's what I think we need to do to  
5 move -- move forward, guys, and I  
6 apologize for not directing it this way  
7 earlier, but I didn't -- I didn't really  
8 know -- know -- I didn't focus, I guess is  
9 the right way to put it.

10 I think we need to -- to -- to  
11 organize a BRG as soon as possible. I  
12 think, David, you ought to be there,  
13 clearly Annette needs to be there, as well  
14 as folks from the -- from the Healthcare  
15 group, you know, Rod and Mike, at least,  
16 and maybe Bill should be there.

17 Let's vet this with BRG, and then I  
18 think this thing goes to, you know, some  
19 subset of the management committee.  
20 Actually, I think we have a reputation  
21 risk subgroup that includes Kenny, Hutch,  
22 and Ian, and Bob Dinerstein, and let's  
23 take -- you know, the issues to them and  
24 -- and figure out what we -- what we --  
25 what we should be doing as UBS Warburg.



---

Contents

SECTION 1 **HEALTHSOUTH Q4 Reconciliation** \_\_\_\_\_ 1

SECTION 2 **Revised Financial Model** \_\_\_\_\_ 3

- APPENDICES
- A Addendum — Pre GSFC
  - B Addendum Two
  - C Addendum Three—HEALTHSOUTH Bank Amendment and Loan

 UBS Warburg

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 215816

# HEALTHSOUTH Q4 Reconciliation

---

SECTION 1

 UBS Warburg

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 215817

*Crang Fitt  
call Peckay* SHEET: WEND: ADD: NOLAN: DOC

**HEALTHSOUTH Q4 EBITDA**

U

**HEALTHSOUTH 4Q 2002 FINANCIALS**

The following analysis adjusts HEALTHSOUTH's Q4 2002 actual performance for one-time items resulting in adjusted EBITDA for Q4 2002 of \$224.1 million.

*4350 ->  
03 2002  
377 ->  
980*

(\$000s)	Q4 Actual	Adjustments	Adjusted Q4	Alex Geier Q4 Estimates
Revenue	\$923,528	(\$165,815) <sup>1</sup>	\$1,089,343	
Operating expenses	822,369	18,953 <sup>2</sup>	803,416	
Corporate G&A	61,063		61,063	
Provision on doubtful account	30,460	10,000 <sup>3</sup>	20,460	
<b>EBITDA</b>	<b>9,636</b>	<b>(194,768)</b>	<b>204,404</b>	
Additional operating expenses			<u>19,665</u>	
<b>Adjusted EBITDA</b>			<b>224,069</b>	<b>220,300</b>

*Talent  
room  
operate*

**NOTES:**

- Effect of change in estimate relating to the valuation of accounts receivable and final cost report settlements for the company's inpatient operations.
- Effect of estimated future obligations relating to certain unfunded contractual retirement benefits.
- Effect of detailed analysis of collectability of accounts receivable.
- In addition, the company incurred significant expenses in the fourth quarter relating to legal, consulting and audit fees incurred in connection with the proposed tax-free separation of the company's surgery center operations and legal, consulting and other professional fees relating to litigation, internal and external investigations and related matters. These expenses are reflected in operating expenses for the quarter and are not included in calculating operating income and operating earnings per share, but management believes that they are not representative of operating expenses that are expected to be incurred going forward.

*\$175 annual  
inpatient  
adjustment  
rehab  
EASH: base  
1Q EBITDA  
275 page  
use August  
guideline  
275*

4th quarter operating expenses as % of sales	73.8%
3rd quarter operating expenses as % of sales	71.9%
Difference	1.8%
Revenue 4th Quarter	\$1,089,343
Additional operating expenses	\$19,665

980

*Common  
Stock*

*Did not intentionally  
public guideline update in  
December -> 2003*

*Andreas said  
use August  
guideline*

*Reducing the amt of business  
controlled through*

*Sept Q  
1Q EBITDA 263*



Tab 28

### Minutes of the Leveraged Commitments Committee Meeting

Meeting Date: 2003-03-06  
(09:00-11:00)

**Attendees:**

**Committee Members:** Chris Ryan (Chairman), David Juge (Loan Syndicate ? 3 March), David Bowden (CRC), Annette Spencer (Committee Counsel), Carel van Randwyck (minutes)  
**Deal Team and others:** Mike Leder (IBD), Rod O'Neill (IBD), Scott Wollard (IBD), Michael Farah (IBD), CJ Corradino (Loan Syndicate ? 3 March), Gary Riddell (CRC), Andreas Wyler (CRC), Ian Francis (CRC), Debbie White (LPRM), Alex Geier (FI Credit Research ? not over the wall), Penate Jacobson (LPRM ? 3 March)

**Transaction:**

**Project Name:** Healthsouth  
**Borrower Name:** Healthsouth Corporation  
**Region:** Americas

**Decision:**

Deferred

Approval is sought from the GSFCC for UBSW to:  
 (1) A request from HEALTHSOUTH Corporation(? HRC?) to amend their existing \$1.25 billion credit facility

(2) Provide HRC with a \$22 million senior secured multiple draw Term Loan to help finance Source Medical, which is 30% owned by HRC

HRC proposes to reduce its credit facility to \$1.1 billion, comprising: \$400 million four-year partially amortizing Term Loan; \$700 million revolving credit facility (RCF).

The Amendment Fee will be 25bps. Margins will depend on HRC's leverage ratio: Undrawn spread ? 27.5bps to 50bps; Drawn spread ? 22.5bps to 35.0bps.

Details of the Source Medical loan are documented in the minutes of 26 February 2003.

HRC is currently rated by Moody's and S&P, respectively, as follows: Senior Implec/Corporate Credit Rating ? Ba3 / BB-; Subordinated debt ? B2 / B; Outlook ? Stable / watch negative.

The Committee deferred the request as presented until the following has been conducted:

- Further analysis of the Q4 2002 financials and 2003 guidance
- Discussion between Craig Pitt (Ratings Advisory) and the S&P analyst for Healthsouth on the background to the ratings change and when the company was advised of this change
- Clarification from the company of issues raised in the meetings (see below).

FI Credit Research informed the Committee of the following:

- HRC announced Q4 2002 results on 3 March; they were worse than expected:
- \* EBITDA of \$204 million compared to expectation of \$220 million, excluding non-recurring items and minority interests)
- \* margins were lower than expected, particularly on the Outpatients Rehabilitation business
- \* HRC reduced legal and accounting costs in Q4 of \$300 million in relation to its recent spin-off
- \* Clinic closure resulted in revenue reduction from Outpatient Rehabilitation, but this was offset by growth in other business streams
- \* August 2002 guidance for Q4 was that the clinic closure would have a \$175 million negative impact on Outpatient Rehabilitation ? actual results were worse
- \* August 2002 Q4 EBITDA guidance was \$275-\$300 million
- Market reaction to the results has been neutral; Q4 results have not changed investors' views on the Company
- Sceptical that the Company will achieve projected 2003 full year EBITDA of \$1bn+ - more likely to be approx. \$980 million

CRC informed the Committee that during a discussion with HRC's Treasurer in the week of 17 February 2003 (i.e. two weeks before the Q4 results were announced), UBSW was advised to use the

<http://fixer.stm.swissbank.com:8181/lfcc.nsf/ReqNum3/B10FF8509...> 10/03/03

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 113234

August guidance for Q4 results as a basis for evaluating HRC.

CRC believes that HRC's actions over the last two weeks have damaged the company's credibility with UBSW.

The Committee was informed that:

- HRC was advised by their S&P analyst on 4 March that the Company's rating would be downgraded one notch and the announcement would be made to the market the following day (5 March); HRC management called the Deal Team on 4 March inquiring on the status of our approval of the amendment, without informing them of the impending downgrade
- HRC is planning to file its Q4 2002 10-K at the end of March 2003
- HRC did not seek the amendment to the \$1.25 billion facility earlier as they were focussed on the Source Medical borrowing needs
- HRC still plans to use Source Medical as the main outsourced provider of admin. services
- The Deal Team has been informed by HRC that approvals to the proposed amendments to the larger facility have been received from Wachovia and Scotia Bank ? verbal approvals are still awaited from JPM, BofA and UBSW
- The amendment to the \$1.25 billion facility includes a springing lien, enabling HRC to take advantage of the \$400 million basket
- It is expected that the covenants on the larger facility will be breached as at 31 December 2002 ? CRC were aware of this and believe it to be the main reason why HRC is seeking an amendment to the facility.

MATERIAL  
REDACTED

Loan Syndicate advised the Deal Team that the covenants on the \$22 million bilateral loan will need to be identical to the amended \$1.25 billion facility. Accordingly, the covenants on the bilateral will need to be amended should the larger facility close after the bilateral. The proposed collateral for the larger facility will have to be subject to satisfaction of the lenders.

Agreed actions:

- Deal Team to:
  - \* Obtain an explanation from the Company as to why we were advised to use August 2002 guidance for Q4 results two weeks before actual results were reported, showing a significant reduction in EBITDA from the August guidance
  - \* Obtain guidance from the Company of the information they plan to provide at the forthcoming bank meeting

<http://fixer.stm.swissbank.com:8181/fcc.nsf/ReqNum3/B10FF8509...> 10/03/03

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 113235

\* Advise the Company not to issue a Borrowing Notice  
 \* Obtain confirmation from the Company that the HRC contracts with Source Medical exist and that the backlog as previously reported has not changed  
 \* Obtain an explanation on the collateral to be provided as security for the \$1.25 billion facility  
 - FI Credit Research and CRC to analyse the Q4 2002 results, 10-K filing and 2003 guidance before the amendment and loan request are reconsidered by the Committee

Deal Reference #: LF11005

CFD Project Code:

Facility No.	Facility Type	Facility CCT	Total Facility Size (any in mln.)	Approved UFX (any in mln.)	Approved Hold (any in mln.)	Current Size (any in mln.)	Final Adjustment (any in mln.)	Category Type	Message Position
	Term Loan	USD	22					N.I.G. Pending	1384 (Leveraged Ln - Hold)
	Term Loan	USD	400					Amendment/Emeration	1384 (Leveraged Ln - Hold)
	Revolving Credit	USD	700					Amendment/Emeration	1384 (Leveraged Ln - Hold)

**RPS Section:**

Deal Status: Pending

Closing Date: (any-mm-yy)

Risk Management Premium: No

UBSW Title: Participant

UBS Title:

Comments:

Client Region: Americas

Industry Sector: Healthcare

Financial Sponsor:

**CRC Section:**

Comments:

Initial CRC Rating:

<http://fixer.stm.swissbank.com:8181/ffc.nsf/ReqNum3/B10FF8509...> 10/03/03

CONFIDENTIAL TREATMENT  
 REQUESTED BY UBS

UBS/C 113236

634

**From:** McGahan, William+  
**Sent:** Thursday, March 06, 2003 3:50 PM  
**To:** O'Neill, Roderick+; michael.leder@ubs.com

Tab 29

I just got my ass whipped by Scrusby and Owens.

- 1) The key is the amendment. So focus only on that for now.
- 2) they need it by tuesday. We MUST get it done.
- 3) n MUST NOT leak into market that we are struggling. If it does we are all dead
- 4) start with a detailed timeline of how information has flowed over the past two weeks. We must all agree on specifics of this by toMorrow am.
- 5) we need information from the company. Get tadd and richard davis working on everything you need asap.
- 6) we MUST get this done or our relationship is over.

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 155137

635

**From:** McGahan, William+  
**Sent:** Thursday, March 06, 2003 4:14 PM  
**To:** O'Neill, Roderick+; michael.leder@ubs.com

Tab 30

Mike and Rod, you two are responsible for getting the hrc bank amendment approved. My entire career is on the line. Work quickly and carefully. Are you on top of this?!!???

Sent from my BlackBerry Wireless Handheld ([www.BlackBerry.net](http://www.BlackBerry.net))

UBS/C 155305

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBSWE-Mail

Tab 31

From: McGahan, William+  
Sent: Thursday, March 06, 2003 5:14 PM  
To: 'michael.leder@ubs.com'; O'Neill, Rodenck+; Lorelio, Benjamin+

Just to fill you in on what I just got. Please get this done asap!!!

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: Scrusby, Richard <rscrusby@healthsouth.com>  
To: McGahan, William+ <William.McGahan@ubsw.com>  
Sent: Thu Mar 06 17:08:05 2003  
Subject: To hell with you guys

I will put up the money myself. Pls call ben and tell him that I will put up the 24 million personally. Can't believe you guys are doing this. I guess since you guys are breaking up the 20 year relationship Ben will understand us moving it all somewhere else. We will comeback strong and kick butt again. Thanks for the help over the years. We had some good times. Richard

-----  
Sent from my BlackBerry Wireless Handheld

Confidentiality Notice: This e-mail communication and any attachments may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

## UBSW E-Mail

From: McGahan, William+  
 Sent: Thursday, March 06, 2003 5:18 PM  
 To: Lorello, Benjamin+  
 Subject: Fw. Tab 32

I hate my job. I resign. Go jump off a bridge.

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: McGahan, William+ <William.McGahan@ubsw.com>  
 To: 'rscrushy@healthsouth.com' <rscrushy@healthsouth.com>  
 Sent: Thu Mar 06 17:13:25 2003  
 Subject:

Richard, I will get it done! I promise! Don't wash us away yet. I have talked to Bill and Tadd and tried to call you and I am all over it. I will call you in the morning with it being done! Bill

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: Scrushy, Richard <rscrushy@healthsouth.com>  
 To: McGahan, William+ <William.McGahan@ubsw.com>  
 Sent: Thu Mar 06 17:08:05 2003  
 Subject: To hell with you guys

I will put up the money myself. Pls call ben and tell him that I will put up the 24 million personally. Can't believe you guys are doing this. I guess since you guys are breaking up the 20 year relationship Ben will understand us moving it all somewhere else. We will comeback strong and kick butt again. Thanks for the help over the years. We had some good times. Richard

-----  
 Sent from my BlackBerry Wireless Handheld  
 Confidentiality Notice: This e-mail communication and any attachments may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

March 7<sup>th</sup>  
3:00 Eastern

HRC  
Todd McVay  
Jason Brown

UBS Credit  
Gary Riddell  
Jan Funk  
Andrew White

UBS  
Mike Keller  
Rob Oke II

Tab 33

- ① HRC asking for a verbal approval of amendment subject to Balance Sheet / Cash Flow / 10K
  - ② Reason: Bank meeting - want to say we have approval
  - ③ Gary wants to be as sure when commitment - verbal or not is given
  - ④ Change in reimbursement  
Significant changes in 4<sup>th</sup> qtr.
  - ⑤ Put together a term sheet from JP Morgan + Wachovia, reduction in UBS commitment, aggressive amortization on term, higher prices, more restrictive on baskets, springing lien on stock of HRC + subs  
[redacted] - upstream pledges
  - ⑥ Balance sheet } will be ready 3/13/03  
Cash Flow }  
10K }
- Todd said there will be no surprises in these documents
- ⑦ Full income statements - Todd said will send them 3/7/03 - afternoon
  - ⑧ Todd said he will not make promises + and
  - ⑨ Cost cutting - elimination regional mgmt. } 4<sup>th</sup> qtr charged off  
- selling airplanes }  
- closing 200+ facilities }  
- personnel }  
- advertising }
  - ⑩ \$ 270 mm of expenses - annual  
\$ 44 mm of corporate overhead sur-charge - annual

⑪ Outpatient rehab } business suffering  
 Diagnostic  
 inpatient } business booming  
 revs } these make up 75% of business

⑫ Schedule of \$270 } cost savings  
 \$44

Though Feb. - these expenses were in line with psychs

⑬ 1.89 - 4th qtr } Revenue  
 1.50 - 1.55 } 1st qtr

⑭ Where is balance sheet?

Todd: we are a lien company  
 - charges took a lot of time  
 - annual mgmt meeting in Orlando  
 - This weekend is full work weekend

Gary: Can we bracket moving pieces?

Todd: Don't know what are moving pieces

Gary: I have a hard time believing there is no balance sheet

Todd: with amount of charges, lot of work on balance sheet

Cash balance = \$390 - same as 3rd qtr / 4th qtr.

Gary: what is minimum working balance cash?

Todd: \$200 mm cash

Gary: Other unusual charges = \$145  
 \$175 - was cash charges - A/R  
 \$60 - walking away from leases which were pre-pay  
 - severance charges

Is cash writing a check?

Gary & Todd agree it is used the word "cash" because buy-side thinks  
 of A/R as cash

UBSW E-mail

From: McGahan, William+  
Sent: Friday, March 07, 2003 11:35 AM  
To: Leder, Michael+  
Subject: Re: Fw: RE:

Tab 34

No

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: Leder, Michael+ <Michael.Leder@ubsw.com>  
To: McGahan, William+ <William.McGahan@ubsw.com>  
Sent: Fri Mar 07 11:33:27 2003  
Subject: Re: Fw: RE:

Rod has already had this discussion clearly with Richard Davis. Do I need to have it separately with Tad as well?

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: McGahan, William+ <William.McGahan@ubsw.com>  
To: Leder, Michael+ <Michael.Leder@ubsw.com>  
Sent: Fri Mar 07 09:10:50 2003  
Subject: Re: Fw: RE:

You should call Tadd and ask if the priority today is the amendment or the source medical loan. Tell him we need to do these one at a time. Then let me know.

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: Leder, Michael+ <Michael.Leder@ubsw.com>  
To: McGahan, William+ <William.McGahan@ubsw.com>  
Sent: Fri Mar 07 09:07:32 2003  
Subject: Re: Fw: RE:

Not promising. Hopefully receiving full quarterly projections and sharing the draft of the K with us will also improve the dialogue.

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: McGahan, William+ <William.McGahan@ubsw.com>  
To: michael.leder@ubs.com <michael.leder@ubs.com>  
Sent: Fri Mar 07 08:42:41 2003  
Subject: Fw: RE:

Fyi

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

UBS/C 15513E

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

From: Ryan, Christopher <Christopher.Ryan@ubsw.com>  
 To: McGahan, William\* <William.McGahan@ubsw.com>  
 Sent: Fri Mar 07 06:23:04 2003  
 Subject: RE:

Internally, not much. Externally, it depends. If the timeline exonerates HRC, you know better than me. If the timeline demonstrates duplicity, I would counsel Scrushy, as a friend and advisor, to change the Company's attitude towards the debt markets. He will need them. - CRR

-----Original Message-----  
 From: McGahan, William\*  
 Sent: Thursday, March 06, 2003 5:26 PM  
 To: Ryan, Christopher  
 Subject: Fw:

Chris, see the e-mail string below from the CEO. Obviously he is pissed. I have Leder putting the timeline together, and also getting the other information from the company. The CEO is solely focused on the amendment, and not the \$22 loan. What else can I do internally not to permanently blow up this relationship by not getting there asap on the amendment? Bill

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
 From: McGahan, William\* <William.McGahan@ubsw.com>  
 To: 'rscrushy@healthsouth.com' <rscrushy@healthsouth.com>  
 Sent: Thu Mar 06 17:13:25 2003  
 Subject:

Richard, I will get it done! I promise! Don't wash us away yet. I have talked to Bill and Tadd and tried to call you and I am all over it. I will call you in the morning with it being done! Bill

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
 From: Scrushy, Richard <rscrushy@healthsouth.com>  
 To: McGahan, William\* <William.McGahan@ubsw.com>  
 Sent: Thu Mar 06 17:08:05 2003  
 Subject: To hell with you guys

I will put up the money myself. Pls call Ben and tell him that I will put up the 24 million personally. Can't believe you guys are doing this. I guess since you guys are breaking up the 20 year relationship Ben will understand us moving it all somewhere else. We will comeback strong and kick butt again. Thanks for the help over the years. We had some good times. Richard

-----  
 Sent from my BlackBerry Wireless Handheld  
 Confidentiality Notice: This e-mail communication and any attachment may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

642

**From:** O'Neill, Roderick+  
**Sent:** Friday, March 07, 2003 4:19 PM  
**To:** Leder, Michael+  
**Subject:** FW: We don't have a balance sheet - move on

-----Original Message-----

**From:** Brown, Jason [mailto:Jason.Brown@healthsouth.com]  
**Sent:** Friday, March 07, 2003 3:39 PM  
**To:** O'Neill, Roderick+  
**Subject:** We don't have a balance sheet - move on

Tab 35

Jason M. Brown  
Vice President-Finance  
HEALTHSOUTH Corporation

Confidentiality Notice: This e-mail communication and any attachments may contain confidential and privileged information for the use of the designated recipients named above. If you are not the intended recipient, you are hereby notified that you have received this communication in error and that any review, disclosure, dissemination, distribution or copying of it or its contents is prohibited. If you have received this communication in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 155363

**MINUTES of the GSF Commitments Committee Meeting**  
**11 March 2003**

**Attendees:**

**Committee Members:** Chris Ryan (Chairman), David Bowden (CRC), Annette Spencer (Committee Counsel), Carel van Randwyck (minutes)

**Deal Team and others:** Mike Leder (IBD), Rod O'Neill (IBD), CJ Corradino (Loan Syndicate), Gary Riddell (CRC), Iain Francks (CRC), Debbie White (LPRM).

**TRANSACTION: HEALTHSOUTH**

Approval is sought from the GSFCC for UBSW to provide a verbal approval of Healthsouth Corporation's ("HRC"/"Company") proposed amendment to their current \$1.25 billion Credit Facility. UBSW's final approval will be subject to UBSW's receipt and satisfactory review of audited year-end 2002 financial statements, a full set of projections and legal documents that accompany the amendment.

HRC has asked for conditional verbal approval of the amendment prior to the Company's bank meeting on Wednesday, 12 March 2003. The Company would like to be in position to announce at the bank meeting that they have received verbal indications of approval from a group of lead lenders that hold a significant portion of the outstanding credit exposure in order to give momentum to the amendment process.

HRC proposes to reduce its credit facility to \$1.1 billion, comprising: \$400 million four-year partially amortising Term Loan; \$700 million revolving credit facility (RCF).

Additionally, the amendment provides for increased pricing and a springing lien mechanism that utilises the lien basket available in HRC's senior notes issues.

The Amendment Fee will be 25bps. Margins will depend on HRC's leverage ratio: Undrawn spread – 27.5bps to 50bps; Drawn spread – 225bps to 350bps.

HRC is currently rated by Moody's and S&P, respectively, as follows: Senior Implied/Corporate Credit Rating – Ba3 / BB-; Subordinated debt – B2 / B; Outlook – Stable / watch negative.

**DECISION: Approved**

The Committee approved the request as presented subject to:

- CRC's approval

CRC highlighted the following:

- Based on the financials provided by the Company, debt reduction over the next three years is minimal
- The term sheet outlining the amendment contemplates a springing lien that would collateralise the amended credit facility obligations and certain hedge arrangements. However, it is unclear who the hedge providers are, how many there are, and the extent of the hedge arrangements – this needs to be clarified with the Company
- The term sheet also contemplates that there will be springing guarantees, that will be triggered when certain leverage covenants are breached, it is unclear how effective and adequate these guarantees will be
- Further explanation is required from the Company on how the springing guarantees and liens (as described on page 30 of the Addendum dated 11 March 2003) will be effected and how the liens will be perfected
- Collateral provided to the lenders under the amended Credit Facility is released when the Company's senior unsecured long-term debt is upgraded to Ba1/BBB-, or better, by Moody's and S&P, respectively
- The majority of the baskets are tightened until leverage is reduced to 3.5x or lower, when the existing terms are re-introduced.

**Agreed actions:**

- Follow-up call by the Deal Team and CRC with the Company.

---

E-mail from Gary Riddell on 14 March 2003 –



Page 2 of 2  
"CRC approved the amendment subject to receipt and satisfactory review of audited year-end 2002 financial statements and legal documentation, as proposed in Addendum #5 dated March 11, 2003."

## MEMORANDUM

**TO:** High Yield Debt Capital Markets      Credit Risk Management  
 Ed Massaro                                      David Bawden  
 David Juge                                        Gary Riddell  
 CJ Corradino                                    Andreas Wyler  
     Iain Franks

**FROM:** Corporate Finance  
 Bill McGahan  
 Mike Leder  
 Rod O'Neill                                      Tab 37  
 Scott Wollard  
 Michael Farah

**RE:** Amendment to HEALTHSOUTH's current \$1.25 billion Credit Facility  
**DATE:** March 11, 2003

## Global Syndicated Finance Commitment Committee

Addendum #5

March 11, 2003

Time: 09:30 pm EST

Dial-in: 1-877-732-4360 US; International 3-303-804-1786

Code: 3209674 Host: Chris Ryan

**PURPOSE**

The purpose of this memorandum is to once again request verbal approval of HEALTHSOUTH's proposed amendment to the Company's current \$1.25 billion Credit Facility. UBSW's final approval would be subject to UBSW's receipt and satisfactory review of audited year-end 2002 financial statements, a full set of projections and legal documents that accompany the amendment. HEALTHSOUTH has asked for conditional verbal approval of the amendment prior to the Company's bank meeting on Wednesday, March 12, 2003. The Company would like to be in position to announce at the bank meeting that they have received verbal indications of approval from a group of lead lenders that hold a significant portion of the outstanding credit exposure in order to give momentum to the amendment process.

As previously discussed, the new \$1.1 billion Credit Facility will be comprised of a \$700 million Revolver and a \$400 million Term Loan. The Term Loan will have scheduled amortization of \$75 million in years 1 and 2, and \$125 million in years 3 and 4. The new Revolver and Term Loan will mature in June 2007. The amendment will provide for increased pricing and a springing lien mechanism that utilizes the lien basket available in HEALTHSOUTH's senior notes issues. In return for these favorable changes, the banks are being asked for their consent to amend the leverage covenant to 4.5x through December 2003 with step-downs thereafter.

 UBS Warburg

CONFIDENTIAL TREATMENT  
 REQUESTED BY UBS

UBS/C 112498

**UPDATE SINCE LAST GSFC CALL ON MARCH 6, 2003**

On Friday, March 7, 2003, HEALTHSOUTH's Tadd McVay, Treasurer, and Jason Brown, VP of Finance, spoke with Gary Riddell, Ian Franks and Andreas Wyler of UBSW's CRM. HEALTHSOUTH explained that they are asking for verbal approval of the amendment prior to the Company's bank meeting on Wednesday, March 12, 2003. The Company would like to say at the bank meeting that they have received verbal approval from a group of lead lenders that hold a significant portion of the outstanding credit exposure in order to give momentum to the amendment process. Tadd McVay explained that HEALTHSOUTH did not provide UBSW with a 12/31/02 balance sheet or cash flow statement because they wanted to ensure that the information they provide UBSW is final. The Company further explained that progress on the balance sheet and cash flow statement had been delayed by the extensive work and discussions needed to finalize the 4<sup>th</sup> quarter charges. Immediately upon completion and release of 4<sup>th</sup> quarter earnings, senior management of the Company left to attend the Company's annual senior management meeting in Orlando, Florida, an event viewed as critical to morale. The management meeting further delayed progress in preparing the balance sheet and cash flow statement. Following the call, HEALTHSOUTH provided UBSW with income statement projections. The accounting and finance departments worked all weekend and all day Monday to be in position to provide UBSW with a draft of the balance sheet and cash flow statement.

On the call we also discussed the events surrounding S&P's downgrade. According to HEALTHSOUTH, a few days prior to the 4<sup>th</sup> quarter earnings announcement, they called David Peknay, S&P analyst, to inform him of their 4<sup>th</sup> quarter charges. David Peknay has been sick with cancer for several months and was on medical leave when HEALTHSOUTH first reported in August 2002 that they would be taking a \$175 million reduction to EBITDA due to changes in reimbursement. As a result, Peknay did not downgrade HEALTHSOUTH at that time (Moody's downgraded HEALTHSOUTH following the August announcement). Peknay informed HEALTHSOUTH he would have to give serious consideration to downgrading the Company. A day in advance of S&P's downgrade, Peknay called HEALTHSOUTH to confirm the fact that S&P was going to downgrade HEALTHSOUTH. The following morning, Bill Owens, HEALTHSOUTH CFO, gave a courtesy call to Bill McGahan informing him of the downgrade. Later that morning, S&P went public with its downgrade.

On Monday, March 10, 2003, Gary Riddell and Ian Franks, had a follow up call with HEALTHSOUTH's Tadd McVay, Treasurer, and Richard Davis, Assistant Treasurer. HEALTHSOUTH discussed the December 31, 2003 balance sheet in great detail including adjustments relating to the 4<sup>th</sup> quarter charges. Furthermore, HEALTHSOUTH offered to send UBSW a draft of the balance sheet and cash flow statement after the call. In the evening, HEALTHSOUTH sent UBSW balance sheets for year-end December 31, 2002 and projected balance sheets.

Attached please find a timeline of events that supports IBD's belief that HEALTHSOUTH has not intentionally misled UBSW or held back information during the amendment process. Also attached are HEALTHSOUTH's income statement projections, HEALTHSOUTH's draft balance sheets and HEALTHSOUTH's covenant compliance forecast. We expect to receive a draft of the cash flow statement from HEALTHSOUTH on Tuesday. Upon receipt of the cash flow statement, IBD and CRM will work together and distribute a revised projection model. Also included in the memo is the term sheet for the proposed amendment.

 UBS Warburg

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 112499

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 UBS Warburg

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS

UBS/C 112500

## UBSW E-mail

From: Ryan, Christopher  
 Sent: Wednesday, March 19, 2003 11:07 AM  
 To: Bawden, David  
 Subject: RE: HealthSouth, Chief Scrushy Accused of 'Massive' Fraud by SEC

he did. in fairness scrushy only stands accused, but it would be hard to characterize \$1.4 bb as constituting a 'grey area'.

-----Original Message-----

From: Bawden, David  
 Sent: 15 March 2003 15:58  
 To: Ryan, Christopher  
 Subject: FW: HealthSouth, Chief Scrushy Accused of 'Massive' Fraud by SEC

Tab 38

Didn't McGahan say he had absolute trust in management?

-----Original Message-----

From: Franks, Iain  
 Sent: Wednesday, March 19, 2003 10:40 AM  
 To: Bawden, David; Riddell, Gary; Wylar, Andreas  
 Subject: HealthSouth, Chief Scrushy Accused of 'Massive' Fraud by SEC

HealthSouth, Chief Scrushy Accused of 'Massive' Fraud by SEC  
 By Judy Mathewson

Washington, March 19 (Bloomberg) -- HealthSouth Corp., the nation's biggest U.S. operator of rehabilitation hospitals, and Chief Executive Officer Richard M. Scrushy committed a "massive" accounting fraud, the Securities and Exchange Commission charged. The SEC alleged in a lawsuit today that since 1999, HealthSouth overstated its earnings by at least \$1.4 billion at Scrushy's insistence in order to meet or beat Wall Street earnings expectations.

The false increases in earnings were matched by false increases in HealthSouth's assets, according to an SEC press release. Scrushy also "knew or was reckless in not knowing" that the companies' financial statements were wrong when he certified them, the SEC said.

Scrushy's lawyer could not immediately be located for comment. HealthSouth's spokesman Jason Brown did not immediately return a call seeking comment.

CONFIDENTIAL TREATMENT  
 REQUESTED BY UBS

UBS/C 229818

## First Cambridge Transaction Overview

Tab 39

### CURRENT REQUEST

HealthSouth ("HRC" or the "Company") is requesting an extension of UBS Warburg's \$82.5 million loan to First Cambridge HCl Acquisitions LLC ("First Cambridge") from January 2, 2003 to March 31, 2003. The initial 4-day loan extension, granted on December 26, 2002 was requested in the context of an overall desire to obtain a 90-day extension for the loan. HealthSouth believes that a 90-day period is sufficient time to execute the sale of the 13 properties to Medical Office Properties, from which the proceeds will be used to pay down the entire amount of the loan. HealthSouth has agreed to the conditions previously discussed for a 90-day extension: cash collateral of \$82.5 million remitted to UBS on January 2, 2003 and ratification from senior management regarding appropriate disclosure of the cash collateralization in the Company's 10-K filing.

### LOAN EXTENSION - 12/26/02

HealthSouth and First Cambridge requested that UBS extend the current 12-month, \$82.5 million loan to First Cambridge by four business days from December 26, 2002 to January 2, 2003, in the context of an overall desire to obtain a 90-day extension for the loan. HealthSouth informed UBS that it has received a Letter of Intent for the purchase of these properties from Medical Office Properties, a privately held REIT, for a purchase price of \$91.9 million. HealthSouth is seeking security over these assets in the event the sale does not proceed by obtaining the mortgages over the properties. HealthSouth asked for the extension in order to ensure sufficient time to obtain security over the assets. At that time, UBS Warburg's exposure was \$64.5 million and due to PIMCO's inability to extend their portion of the facility, UBS was assigned PIMCO's exposure, thereby increasing UBS Warburg's exposure to \$82.5 million.

Approval for the 4-day extension was granted with the understanding that in the event that this loan is extended beyond January 2, 2003 UBS will require \$82.5 million in cash from HealthSouth as collateral for the loan, and that should HealthSouth provide cash collateral for the loan, it would be reported as a footnote in the Company's 10-K filing.

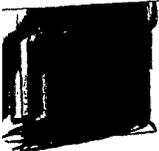
### ORIGINAL TRANSACTION - 12/27/01

In December 2001, UBS acted as Lead Arranger on a 12-month, \$82.5 million senior unsecured term loan to First Cambridge HCl Acquisitions LLC, a special purpose entity created by Healthcare Capital Investors ("HCI"), a healthcare real estate investment trust ("REIT") and a division of Cambridge Holdings Inc. The proceeds were used for the purchase of 13 HealthSouth properties. The agreement between First Cambridge and HRC was initially structured as a sale-leaseback. The properties were triple-net leased, under one master lease agreement, for 15 years with the option to extend the lease agreement in annual increments after the initial expiration of the master lease. HRC also maintained the option to buy back the facilities upon expiration of the initial master lease. The loan to First Cambridge was unsecured, but guaranteed by HealthSouth - it is bound by a duly executed Keepwell Agreement. First Cambridge originally intended to close additional acquisitions of selected healthcare properties within the first 3-6 months of 2002 at which point First Cambridge would have conducted an Initial Public Offering ("IPO"). Proceeds from the IPO would be used to pay down the entire amount of the loan.

 UBS Warburg

UBS/C 148593

CONFIDENTIAL TREATMENT  
REQUESTED BY UBS



Tab 40

Bill Owen (BO): Is it on or off?

(13:31:07)

Unidentified Party (UP): ???

BO: How do I turn it off?

UP: Just power it down.

BO: Do I need to put a new battery in it when I get back to the office and turn it back on again?

UP: ??? (inaudible)

BO: ??? (inaudible)

(In car for a while)

(Cell phone ring)

13:50:27

BO: Hello. Yeah. Hey Tadd, uh, when I called earlier they had turned this recorder off. It's on right now, so you and I probably shouldn't talk until I get it taken off again. Yeah. Well, what I got to tell you, they've heard, so -- cause they heard it this morning when it was said the first time. I got a very disturbing phone call this morning from Bill McGann, who is one of our bankers from UBS Warbert. And he just called me and said, How are you doing? And I responded, We're doing fine. And he said no, No. How are you doing? And I said, Fine. Why? He said, Well, I'm just calling to let you know that in case Richard decides he is just going to try to pin all this on you, don't forget you've got friends and it will be ok and we'll just play lots of golf. Now, he shouldn't -- he doesn't know anything that is going on, so, you know, it sounds to me like he was just saying to me if Richard tries to blame you for the turn-down of the business and runs you off -- but what concerns me is that maybe he's heard some conversations or second or third-hand stuff, because Bill has his fingers on a lot of stuff ....in New York....(silence-other person) Yeah, well we went to the different approach and now I actually have this thing in my belt and so I am going to make one last shot at it. We didn't get anything this morning so I am going to make one last shot at it this afternoon. No, I mean it got the conversation, but there wasn't anything good. George was trying to find you earlier, said they had something to fax to you. He just asked me where you were and I told him last time I talked to you, you were in the office....(end of conversation...getting out of car) OK Bye.

\*\*\*\*\*

13:57:31

BO: (Making a phone call) Hey, how did Saudi Arabia end up with a negative? Did we not book

**Hirsch, Hal**

---

**From:** Davis, Lanny [LDavis@PattonBoggs.com]  
**Sent:** Saturday, September 14, 2002 4:31 PM  
**To:** 'hhirsch@fulbright.com'  
**Subject:** Cell battery out Tab 41

You will represent Audit Comm. Will call later.

This e-mail message contains confidential, privileged information intended solely for the addressee. Please do not read, copy, or disseminate it unless you are the addressee. If you have received it in error, please call us (collect) at (202) 457-6000 and ask to speak with the message sender. Also, we would appreciate your forwarding the message back to us and deleting it from your system. Thank you.

To learn more about our firm, please visit our website at <http://www.pattonboggs.com>.

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 011176

CONFIDENTIAL  
TREATMENT REQUESTED

HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
SEPTEMBER 17, 2002

## MINUTES

Tab 42

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated September 17, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., C. Sage Givens, Charles W. Newhall III, Larry D. Striplin, Jr. and Joel C. Gordon. The following guests were also present: Larry D. Taylor, President and Chief Operating Officer — Surgery Center Operations of the Corporation, Patrick A. Foster, President and Chief Operating Officer — Inpatient Services of the Corporation, Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Weston L. Smith, Executive Vice President of the Corporation, Daniel J. Riviere, President — Ambulatory Services of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, Susan Smith, Senior Vice President — Reimbursement of the Corporation, Jean Davis, Vice President — Operations of the Corporation, Eric R. Hanson of U.S. Strategies, William C. McGahan and Benjamin D. Lorello of UBS Warburg LLC, J. Michael Rediker and Thomas L. Krebs of Haskell Slaughter Young & Rediker, Lanny J. Davis, Debra M. Laboschin and Raphael Larson of Patton Boggs, LLP, Michael Deaver of The Edelman Group, and Thomas C. Fox and Scot T. Hasselman of Reed Smith LLP. With the exception of Messrs. Hanson, Davis and Deaver, all Directors and guests were physically present in the Board Room. Messrs. Hanson, Davis and Deaver participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

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The Meeting was called to order by Mr. Scrusby at 2:35 p.m. C.D.T.

**SCA Update**

Mr. Taylor provided the Board with an update on surgery center separation activities. He reviewed the new SCA logo, the Mission Statement and the organizational structure. He also outlined several other key initiatives critical for success.

**CMS Regulations Review**

Mr. Owens introduced Ms. Smith and Ms. Davis and asked them to present a history of CMS activity from 1998 to the present with regard to reimbursement for concurrent or group therapy provided by physical therapists. Ms. Smith and Ms. Davis presented a detailed history using correspondence from CMS and documentation from HEALTHSOUTH and HEALTHSOUTH's reimbursement counsel regarding outpatient therapy reimbursement issues.

Mr. Owens also introduced Matt Zurek, Regional Vice President — Operations, and Rob Tillman, Vice President — Clinical Development, both physical therapists. Messrs. Zurek and Tillman discussed with the Board how physical therapists within the industry treat patients with regard to concurrent and group therapy. Both felt that HEALTHSOUTH's practices were consistent with the industry and what is taught in the physical therapy schools.

At this point Mr. Lanny Davis of Patton Boggs joined the meeting via telephonic connection. Mr. Davis and his firm were hired by the Corporation to consult on legal and media relations matters facing the Corporation. Mr. Davis spent several minutes discussing strategy and the scope of his firm's involvement.

Mr. Rediker and Mr. Krebs discussed with the Board the strategy for defending the shareholder and derivative lawsuits. Mr. Rediker stated that the cases were winnable and the Corporation should be aggressive with a proactive strategy which could produce newsworthy developments.

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TREATMENT REQUESTED

**Corporate Compliance**

Mr. Gordon advised the Board that he and Messrs. Watkins and Newhall had a telephone conference on September 13, 2002 to discuss the need for an independent investigation of allegations of insider trading and improper disclosure. Mr. Gordon recommended the firm of Wilmer, Cutler & Pickering and Mr. Newhall recommended the firm of Fulbright & Jaworski, L.L.P. to conduct the independent investigation on behalf of the Board.

Mr. Scrusby asked Mr. Rediker to comment on the independent investigation and to give the Board recommendations on other matters to consider. Mr. Rediker recommended the Board establish a special litigation committee of the Board of Directors, comprised of independent directors to investigate the derivative lawsuits. This committee would conduct their investigation concurrent with the independent investigation conducted by an outside law firm. To establish a special litigation committee, Mr. Rediker advised the Board that it would need to add an additional outside director who met the test of independence.

After discussion, upon motion duly made by Mr. Chamberlin and seconded by Dr. Watkins, the following resolution was unanimously adopted:

RESOLVED, that the number of Directors constituting the whole Board of Directors shall be ten.

There after, upon motion duly made by Dr. Watkins and seconded by Mr. Chamberlin, the following resolution was unanimously adopted:

RESOLVED, that Jon F. Hanson is hereby appointed to serve as a Director of this Corporation until the next Annual Meeting of Stockholders of this Corporation and until his successor is duly elected and qualified, or until his earlier death, resignation or removal.

After discussion of the special litigation committee and the independent investigation, Mr. Davis stated that he felt Fulbright & Jaworski would be the better choice to conduct the independent investigation.

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TREATMENT REQUESTED

After further discussion, upon motion duly made by Dr. Watkins and seconded by Ms. Givens, the following resolutions were unanimously adopted:

RESOLVED, that having considered the claims made by Wade Tucker, purporting to be a shareholder, against the Company, Richard M. Scrushy, an officer and director of the Company, Gerald P. Scrushy, MedCenterDirect.com, Source Medical Solutions, Inc., Capstone Capital Corporation, and G.G. Enterprises. Case No. CV02-5212, Circuit Court of Jefferson County, Alabama, filed August 28, 2002 without prior demand on the Company's Board of Directors, in the form of a derivative action (the "Tucker Action"), and taking into consideration the Company's plans to move to dismiss or stay the Tucker Action, and desiring to preserve to the Company and the Board to pursue such motions to dismiss or stay while otherwise delegating to an appropriate committee the powers and discretions to conduct the review of the Tucker Action and any related matters and issues as set forth below, the Board of Directors hereby constitutes and appoints a Special Litigation Committee (the "Committee"), which will consist initially of existing director Larry D. Striplin, Jr. and new director Jon Hanson (and, subsequently, of such additional independent directors, if any, as the Board of Directors may appoint from time to time), to investigate, review and analyze: (1) the facts, transactions, events and circumstances surrounding the claims made in such Tucker Action and any other actions or proceedings which may be filed which relate or are alleged to relate to any event or transaction which is a subject in or of the Tucker Action; and (2) to the extent the Business Judgment Rule may be determined to be applicable thereto or to the extent claims of a derivative nature may be asserted in respect thereto, any events or transactions which are or may become the subject of any of the pending federal court class actions which have been filed against the Company since August 27, 2002 in the United States District Court for the Northern District of Alabama.

FURTHER RESOLVED, that such Committee shall consider and determine whether or not prosecution or continuation of such claims and actions is in the best interests of the Company and its shareholders, and what action the Company should take with respect thereto;

FURTHER RESOLVED, that such Committee is hereby authorized and directed to continue in existence until such time as the Committee shall recommend its dissolution to the Board of Directors, and to engage such experts and advisers, including independent legal counsel, as the Committee shall deem necessary or desirable in order to assist it in the discharge of its responsibilities;

FURTHER RESOLVED, that the Committee shall have and may exercise in connection with its investigation and determination all the powers and authority of the Board of Directors, which is hereby delegated to the Committee, and such other powers as are accorded to such a committee under applicable law;

FURTHER RESOLVED, that nothing herein is intended to moot or waive the Company's planned motions to dismiss or stay the Tucker Action for lack of standing

CONFIDENTIAL  
TREATMENT REQUESTED

and/or failure to state a claim upon which relief may be granted and failure to comply with the requirements of Rules 12(b)(6) and 23.1, Alabama Rules of Civil Procedure; provided, however, that the Committee shall have full power and discretion to recommend that any Company motion or pleading be changed, withdrawn, or supplemented by additional or substituted pleadings or motions of the Committee or the Company, or both, as shall be deemed appropriate;

FURTHER RESOLVED; that the determinations made by the Committee shall be final, shall not be subject to review by the Board of Directors and shall in all respects be binding upon the Company;

FURTHER RESOLVED, that the officers, agents, and employees of the Company, and each of them, are hereby authorized and directed to assist the Committee and to provide it with all information and documents that it shall request with respect to the subject matter of the Tucker Action and any actions or proceedings related to the subject matter of the Tucker Action, having due regard for any applicable privileges.

After further discussion, upon motion duly made by Dr. Watkins and seconded by Ms. Givens, the following resolutions were unanimously adopted:

RESOLVED, that this Corporation is authorized to engage the services of Fulbright & Jaworski, LLP to conduct a review of such matters relating to pending litigation and investigations regarding this Corporation as may be directed by the Board of Directors and encompassed in one or more engagement letters executed between this Corporation and Fulbright & Jaworski, LLP.

RESOLVED, that any reports or other work product created by or at the direction of Fulbright & Jaworski, LLP pursuant to the foregoing resolution shall be made available to the Special Litigation Committee as it may request.

Mr. Striplin then affirmed that he has no financial relationship with Mr. Scrusby and was not an investor in MedCenterDirect, Source Medical or Capstone Capital.

**CEO Report**

Mr. Owens updated the Board on operational and financial results to date for the current quarter. He also discussed with the Board the Corporation's decision to suspend guidance at the present time.

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TREATMENT REQUESTED

#### UBS Warburg Comments on Surgery Center Transaction

Messrs. McGahan and Lorello reviewed in detail with the Board current issues surrounding the spin or split of the surgery division.

#### Confidentiality Statement

Mr. Rediker stated to the Board and to agents of the Board participating in the meeting the importance of confidentiality and the nature of insider information being shared and discussed.

#### Review of Investor Conference Call

Messrs. Scrusby and Davis reviewed with the Board the key components of the investor conference call scheduled for September 19, 2002.

#### Other Matters

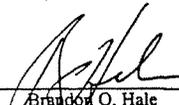
At the close of the Meeting, Hal Hirsch of Fulbright & Jaworski joined the meeting via telephonic connection to accept the assignment to conduct the independent investigation and confirmed that Fulbright & Jaworski had no prior involvement with the Corporation.

Mr. Gordon discussed with the Board his views on the role of the Compliance Committee in regard to the investigation by Fulbright & Jaworski and his desire that the Compliance Committee and the full Board be kept informed of all relevant information on a current basis.

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrusby  
Chairman of the Board



Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

HS-71515.1

B20 9/17/02

BOD  
9/11/02

RMS WTR PCUR ~~EXX~~  
CSG CUN JSC JCG LRS

start 2:35 PM

Guests T. Milroy, W. Smith, L. Taylor  
D. Foley, P. Foster, P. Brinson  
B. Foster, Eric Hanson  
D. H. McGowan, Bea Lucella

Mike Rediker, Tom Keeble  
K. Hoffman

Surgery Separation Progress - Larry Taylor

- New logo stamp
- Mission Statement
- Location Map -> 37 states
- 212 Total Locations
- Executive Management Team
- Service Management Team
- Field Managers
- Development Team
- Strong Audit Leads
- Resynchronization Process
- Surgery Center Case Mix
- Health Information Services

Clinical Services  
 Managed Care Contracting  
 Dedicated Sales Force  
 Physician Advisory Boards  
 Professional Boards  
 Surgical Ex-donors  
 Corporate Benchmarks  
 Regional Clinical Excellence  
 Recap of Banking Meetings  
 SEC Preparation  
 Shared Services  
 Competition  
 Summary

~~6/11/02~~ → Review of History - CMS Regulations relative to concurrent therapy + group therapy  
 (Sara Smith, Jean Davis, Tom Fox with Bud Smith, Matt Zwick + Rob Tillman (+ Scott + Howard))

~~History~~  
 See ~~History~~ History from 1998 to present on CMS Regulations  
 HealthSouth's position has been the same  
 Issues we have been firm + consistent

HHEC 293-0321  
 Confidential Treatment  
 Requested by HealthSouth Corp.

April 1999 Draft Program Memo/Recommendation  
 April 1999 notes from Jean Davis (transcript)  
 March 2002 Program Recommendation - Final

Jason Henry  
2 attorney  
meeting  
+ joined the  
Patent  
Firm

April 5 2001 Website  
Federal Register May 2001

\* July 31 2001 Fed Reg  
May 17 2002 Transmitted

Lower David  
Attorney - S  
the case

HealthSouth got copy June 6 from <sup>our</sup> attorney

Book 2

Jan 21 - Susan Jones Memo to Bill Hiden

Jan 25 - Susan Jones Memo to Dr. McKimney

Jan 28 - Dr. McKimney response

July 10 - Letter to Tom Brisson from Eckhardt

July 19 - Meeting with Jean Davis, Steve Sped and  
Tom Brisson with CMS

August 7, Memo to Tom Brisson from Jean Davis

August 15<sup>th</sup> Meeting with Tom Brisson, Susan Jones,  
Jean Davis, Larry Taylor and Matt Zurek

August 16 - Reported by to WFO that 1728 applied to  
IL as well as of therapy

Tom Fox - <sup>Reid Smith</sup> legal opinion issued Nov 2000  
update on legal position - Fed HS  
is in very good position to defend

Matt Zurek + Rob Tillman - Discussed actual  
practices of PT's within HealthSouth  
and throughout the industry

Michael Dennis - Adham

Mike Dennis - via telephone  
Sally Powell - Not on call  
Larry Dennis - via telephone

Larry Dennis

Discussed in general his involvement in  
the legal + positioning of HealthSouth legally  
and perceptually through the Media

Introducer of Mike Dennis

Presentation by Mike Rediker + Tom Keebs

Discussed strategy of dealing  
shareholder lawsuits + derivative lawsuits

5:05 - Break For Dinner

6:00 - Re-convene

(with regard to Debra's case)

Mike Rediker - This case is winnable  
and the Company should be  
aggressive - with proactive strategy  
which could produce some news worthy  
developments

Joel Gardner - Called Boft and asked if  
Compliance Committee should investigate  
Boft said no

Compliance Committee recommends

- Gordon Finds the Compliance Committee has the responsibility to investigate the allegations

RMS asked Mike Reblin to give Board recommendation on how to address what Gordon is recommending

- 1) Mike Reblin
- 1) Board can decide whether to make change
  - 2) Futility rule

Get explanation from Gordon

Recommendations Special Litigation Committee (SLC)

- 1) No financial interest in transaction
- 2) Don't report to those whose interests caused lawsuit
- 3) Thorough in investigation
- 4) Requires action of entire Board

Fulbright & Jaworski

Lance Davis Finds that Fulbright & Jaworski would be the better choice than Wilmer, Cutler

Action to increase size of Board

- 1) children
- 2) with

Name for Advisor to Board

- 1) Wilmer
- 2) Cutler

① Stephen Attomation that he has an  
 forward relationship with Rick &  
 not related to MCO/Source/Contract

Notes for <sup>adoption of</sup> SEC resolution to set up SEC  
 @ Vetter  
 @ Green

CEO Presentation - WTD - updates on Qtr

→ Discussion of why we suspended guidance  
 → Discussion of when we are quarter to date

- Complexity of establish exact effect of  
 transmitted on all non-medical contracts

Estimate of quarter was \$ .28  
 impact -.28  
 .20

Base Minimum \$ .11  
 If Sept strong \$ .20

Cash collections strong  
 DSO's should be improving

UBS Warburg Bill McEwan / Ben Lomello

Issues

- ① spin vs split
- ② Stock Price
- ③ synerg EBITDA
- ④ bonds

Analysis →

Why Buy Stock Price

- ① Fear that back rebound to 1997
- ② leverage - would we have a sale
- ③ Access to capital
- ④ ongoing possibility of what business

Opportunity

→ Effect on Share Price

\* Mike Redden of the board  
 Statement to Board & Agents  
 on insider information and  
 importance of confidentiality

RAS Review of Thursday Conference Call

~~Fisher~~ Hal Horach - Fulbright + Jaramila - accepted the assignment

Artie Reiter discussed resolution with Hal on resolution passed by board

L Confirmed no prior involvement with company or part of Fulbright + Jaramila

Review of Conference Call

Key Comments by Nancy Davis

- ① Get along rules
- ② Fairness
- ③ Guilt by association - disprove
- ④ RAS be very personal + direct
- ⑤ Commitment to transparency

→ Joel Gardner comments about being set up by other board members H

Alban 8:30 PM - Discussion  
- RAS Comments

**RESOLUTION APPOINTING SPECIAL LITIGATION COMMITTEE**

RESOLVED, that having considered the claims made by Wade Tucker, purporting to be a shareholder, against the Company, Richard M. Scrushy, an officer and director of the Company, Gerald P. Scrushy, MedCenterDirect.com, Source Medical Solutions, Inc., Capstone Capital Corporation, and G.G. Enterprises, Case No. CV02-5212, Circuit Court of Jefferson County, Alabama, filed August 28, 2002 without prior demand on the Company's Board of Directors, in the form of a derivative action (the "Tucker Action"), and taking into consideration the Company's plans to move to dismiss or stay the Tucker Action, and desiring to preserve to the Company and the Board to pursue such motions to dismiss or stay while otherwise delegating to an appropriate committee the powers and discretions to conduct the review of the Tucker Action and any related matters and issues as set forth below, the Board of Directors hereby constitutes and appoints a Special Litigation Committee (the "Committee"), which will consist initially of existing director Larry D. Striplin, Jr. and new director John Hanson (and, subsequently, of such additional independent directors, if any, as the Board of Directors may appoint from time to time), to investigate, review and analyze: (1) the facts, transactions, events and circumstances surrounding the claims made in such Tucker Action and any other actions or proceedings which may be filed which relate or are alleged to relate to any event or transaction which is a subject in or of the Tucker Action; and (2) to the extent the Business Judgment Rule may be determined to be applicable thereto or to the extent claims of a derivative nature may be asserted in respect thereto, any events or transactions which are or may become the subject of any of the pending federal court class actions which have been filed against the Company since August 27, 2002 in the United States District Court for the Northern District of Alabama.

FURTHER RESOLVED, that such Committee shall consider and determine whether or not prosecution or continuation of such claims and actions is in the best interests of the Company and its shareholders, and what action the Company should take with respect thereto;

FURTHER RESOLVED, that such Committee is hereby authorized and directed to continue in existence until such time as the Committee shall recommend its dissolution to the Board of Directors, and to engage such experts and advisers, including independent legal counsel, as the Committee shall deem necessary or desirable in order to assist it in the discharge of its responsibilities;

FURTHER RESOLVED, that the Committee shall have and may exercise in connection with its investigation and determination all the powers and authority of the Board of Directors, which is hereby delegated to the Committee, and such other powers as are accorded to such a committee under applicable law;

FURTHER RESOLVED, that nothing herein is intended to moot or waive the Company's planned motions to dismiss or stay the Tucker Action for lack of standing and/or failure to state a claim upon which relief may be granted and failure to comply with the requirements of Rules 12(b)(6) and 23.1, Alabama Rules of Civil Procedure; provided, however, that the Committee shall have full power and discretion to recommend that any Company motion or pleading be changed, withdrawn, or supplemented by additional or substituted pleadings or motions of the Committee or the Company, or both, as shall be deemed appropriate;

FURTHER RESOLVED; that the determinations made by the Committee shall be final, shall not be subject to review by the Board of Directors and shall in all respects be binding upon the Company;

FURTHER RESOLVED, that the officers, agents, and employees of the Company, and each of them, are hereby authorized and directed to assist the Committee and to provide it with all information and documents that it shall request with respect to the subject matter of the Tucker Action and any actions or proceedings related to the subject matter of the Tucker Action, having due regard for any applicable privileges.

**Hirsch, Hal**

---

**From:** Hirsch, Hal  
**Sent:** Wednesday, September 18, 2002 1:26 PM  
**To:** '9973706@skytel.com'  
**Subject:** Chronology Tab 43

With SEC inquiry now open, we need to move off chronology. Without the SLC review and with the open investigation we cannot put Richard in a position to a possible inconsistent statements on the stock events. Your call. Let me know.

-hnh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

This email message and any attachments are for the sole use of the intended recipient(s) and contain confidential and/or privileged information. Any unauthorized review, use, disclosure or distribution is prohibited. If you are not the intended recipient, please contact the sender by reply email and destroy all copies of the original message and any attachments.

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 011181

**Goldberg, Adam**

**From:** Davis, Lanny  
**Sent:** Saturday, September 21, 2002 8:00 PM  
**To:** Goldberg, Adam  
**Subject:** Fw: HealthSouth -- Privileged and Confidential

Reaction OTR?

Tab 44

-----Original Message-----  
**From:** Davis, Lanny <LDavis@PattonBoggs.com>  
**To:** 'ldavis1458@aol.com' <ldavis1458@aol.com>  
**Sent:** Sat Sep 21 19:48:56 2002  
**Subject:** Fw: HealthSouth -- Privileged and Confidential

-----Original Message-----  
**From:** LDavis1458@aol.com <LDavis1458@aol.com>  
**To:** mkendrick@pattonboggs.com <MKendrick@PattonBoggs.com>; jjonas@pattonboggs.com <JJonas@PattonBoggs.com>; grasmussen@pattonboggs.com <GRasmussen@PattonBoggs.com>; dlodge@pattonboggs.com <DLodge@PattonBoggs.com>; spape@pattonboggs.com <SPape@PattonBoggs.com>  
**CC:** ldavis@pattonboggs.com <LDavis@PattonBoggs.com>  
**Sent:** Sat Sep 21 19:43:20 2002  
**Subject:** HealthSouth -- Privileged and Confidential

Martha-- I am disappointed that you chose to send and copy a long email after our conversation, especially one that does not accurately reflect our conversation and the current situation and its circumstances of which you were aware. I respectfully suggest it would have been better for you to wait for the two of us to sit down and sort this out -- which could have taken place on Monday or Tuesday (now it will have to be Tuesday.) Therefore, I am forced to amplify my earlier email to the above, which was inevitably too abrupt as a result of the use of my Blackberry. I propose if we cannot sort this out ourselves, then I propose we submit our positions to the Managing Partner and the full Executive Committee to determine what their reaction is. Here is my summary of the facts and circumstances, in brief, so that the others to whom you copied the email can better understand what happened:

1. I received the call from a representative of HealthSouth Monday, Sept. 9, inviting me to serve as counsel or co-counsel, representing the Company and any named individuals in senior management, in the class action litigation alleging securities fraud as a result of stock transactions and statements made in two August 2002 press releases and in defense of any SEC investigation or action that might occur. I agreed to meet with the chief executives of HealthSouth in order to determine whether I would even consider taking the case. I visited with HealthSouth on Friday, September 13. Jody Powell of Powell Tate and Mike Deaver of Edelman were also retained concerning public relations. It was understood that I would also be involved in the public relations strategy as well, working with Jody and Mike. I made the trip to HealthSouth with Jody Powell; (Mike Deaver, who couldn't make the trip, and I met in my office on Monday, September 16.) I did due diligence during my visit, as well as throughout the week of September 16, interviewing over a dozen individuals at HealthSouth, including the Chairman/CEO, the CFO, the General Counsel, and a dozen other employees with knowledge of the matters. Based on that preliminary investigation, I concluded that there was a strong defense in the class action case and in any SEC investigation and I indicated that, subject to clearance of conflicts of interest, I and the firm would be willing to serve as defense or co-defense counsel in the class action case. I was also asked to consider serving as co-counsel in a derivative shareholder case and a qui tam case with some but not all similar issues.

Incidentally, I estimated a budget of at least \$75,000-\$100,000 per month UFN to the Chairman and CEO, with a \$100,000 up front retainer, and he said that would be acceptable .

2. The paper work proposing a new CFM, and the usual conflicts check and clearances, was delayed during the because of religious holidays and personal and professional emergencies last week. I sincerely regret that. The paperwork will be circulated in the next several days. There were emergency circumstances that required me to act for the Company immediately, as of Sunday evening, September 15 (the eve of a high holy day) and to serve as a public spokesperson, which I would prefer to explain in person. I understand that it would have been better, in ordinary circumstances, not to have done so prior to the completion of the internal conflicts and clearance process established by the firm and which I fully support. Again I sincerely regret that.

2. Having made the decision to act for the Company on September 15 evening, and to serve as a spokesperson under the emergency circumstances then faced by the Company, I recognized the risk I was taking in that there could turn up to be an actual conflict of interest and, thus, I would be forced to withdraw. Since I had not entered an appearance in any case, it was my judgment that that was an acceptable risk. Again, I regret at the very least not giving a heads up to the Managing Partner regarding the situation then or up to the present. I should have. In any event, based on my current knowledge, I do not believe there is an actual conflict of interest in with AMPRA in defending HealthSouth in these various cases filed against it. I hope that, after sufficient investigation, that will remain to be the case. If there is, or with any other firm client, then of course I will have to withdraw from the representation.

3. As I explained to Martha, the core issue is whether it is appropriate for the CMS (the Medicare/Medicaid agency, formerly HCFA) should require "group" - level reimbursement under Medicare rules whenever a physical therapist is treating more than one person, regardless of whether the two individuals are receiving different procedures or treatments. The other core issue is whether the Chairman and CEO sold stock and repaid a stock loan with advance knowledge of the proposed rules change by the CMS. I am convinced as of now that he did not and there is a strong defense to the litigation.

4. Based on what Martha has told me about her representation of AMPRA, and the email she has circulated to the above, I am even more convinced that there is no actual conflict of interest in my representation of HealthSouth in this litigation as defense counsel.

5. Finally, all I will say about the rest of Martha's comments about HealthSouth, is that they are partially inaccurate and certainly incomplete. I also wish to say that in our telephone conversation Martha told me flatly that HealthSouth had committed illegal acts in the past -- not as a "report" of what she had heard but as a fact. I asked her not to make such an assertion, not only in light of the presumption of innocence, but also as a courtesy to a fellow partner. She has apparently repeated that assertion to Garret Rasmussen in the last two days. I respectfully suggest that she cease making such statements, and certainly not to anyone outside of the firm.

At this juncture, given Martha's decision to circulate this email, I am not willing to agree that she forward anything from me regarding our representation to anyone outside of the firm. Having said that, I am more than willing to sit down with Martha and try to do everything I humanly can to mitigate, if not eliminate, any negative ramifications regarding her and the firm's relationship with AMPRA.

I look forward to talking with you, Martha, in the next several days and trying to work this out.

Lanny Davis

PB 02824



Going forward, I will remain in daily (hourly sometimes) ongoing consultation and communications with Eric Hanson and Jason Hervey on all matters, particularly the coordination of legal/media/lobbying strategies.

#### Agenda

The agenda for tomorrow is as follows. I understand I will start with a meeting at your house.

1. Fulbright Report. Goal: Start with review of Richard Scruschy knowledge of CMS rule change, time line, etc., in order to make findings on this issue in the next ten days. Then proceed with Company review. Another possible subject for review: an assessment of assessment of financial strength of company, financial reporting, etc.
2. Pro-active press stories in two areas, neither of which focuses on HealthSouth:
  - Why and how CMS new rule was born in bureaucratic confusion and will have devastating impact on seniors -- this is not about HealthSouth but about the confused CMS. Core example of confusion is Mr. Scully -- who when he presided over the FAH that strongly supported concurrent therapy, then he allowed 1753 to issue, then he made it effective only July 1, then he said it was a "gray area," then a week later he said it was not, etc. W. Post target newspaper, or National Journal/Roll Call.
  - Growing opposition to CMS new rule among national associations, senior citizens, physical therapists, hospitals, and other providers and caretakers concerned about senior citizens who rely on Medicare. NY Times is target/WSJ too.
3. Lobbying effort: Eric Hanson to report. Goal: To suspend implementation of new CMS rule pending rulemaking procedure, with notice and comment.
4. Grassroots organization: To assist in the two non-HealthSouth press stories described in #2 and the lobbying effort described in #3, we need to retain an outside organization that specializes in generating grassroots communications -- by email and phone/mail. I have consulted with many people over the weekend, and I have two recommendations. A "Coalition" of hospitals, PT providers, therapists, and senior citizen groups can be organized, and individuals can be encouraged to communicate their opposition.
5. Third Party Legal Challenge to CMS: Preparing a case that might be filed by representatives of seniors, physical therapists and hospitals, including their trade associations, seeking to enjoin the new CMS rule until a valid rulemaking, notice and comment, etc., has been conducted. We have assessed this case already, as have your other attorneys. I believe it suggests a strong likelihood of success.

Look forward to seeing you tomorrow. And thanks to you, Eric and Jason for trusting me so much as you have. I promise you I am totally 100% committed.



2550 M Street, NW  
Washington, DC 20037-1352  
202 457 6000  
Facsimile 202 457 6315  
www.pattonboggs.com

September 23, 2002

Tab 46

Mr. Richard M. Scrusby  
Chairman of the Board  
HealthSouth  
One HealthSouth Parkway  
Birmingham, AL 35243

Re: Engagement of Patton Boggs LLP

Dear Richard:

This is to confirm HealthSouth's retention, as of September 12, 2002, of Patton Boggs LLP, to represent HealthSouth and/or senior management, including yourself personally, in connection with pending litigation, and SEC investigatory matters. In the event that at some future point the firm cannot be consistent with its ethical obligations continue to represent both HealthSouth and Mr. Scrusby, the firm will continue to represent Mr. Scrusby and will assist the Company as appropriate in retaining counsel.

We look forward to working with you on this engagement.

To ensure that HealthSouth and we have a common understanding of the terms of our representation and to comply with the rules of professional conduct for the jurisdictions in which we practice, I have enclosed a statement describing the standard terms of engagement for legal services to be provided by Patton Boggs LLP. The terms of engagement cover such matters as our procedure for handling potential conflicts of interest, fees, costs and expenses, billing arrangements and terms of payment. Please review the document carefully to ensure that it comports with your understanding. This letter supplements and modifies the enclosed terms of engagement.

I will be primarily responsible for the work done on behalf of client and will supervise the lawyers and other professionals who may work on this project. I anticipate that associates, staff attorneys, legal assistants, specialists and/or in-house consultants will assist in the matter.

PB 00138

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

HealthSouth Engagement Letter  
September 23, 2002  
Page Two

As explained more fully in the terms of engagement, we will determine our legal fees based on our standard hourly billing rates in effect when the work is performed and the number of hours worked by each attorney. Our hourly billing rates for most of our partners range from \$220 to \$510; and the hourly rates for most of our associates range from \$180 to \$300. Our legal assistants generally have hourly billing rates ranging from \$50 to \$130. The billing rates of certain lawyers with special expertise or extensive experience may be outside these ranges. My time is billed at \$510 per hour. If you would like to know the hourly billing rates of other billers most likely to work on a particular project, please call me. Generally, we adjust our billing rates for partners in January and those of our associates in October. In addition to our fees for legal services, we also charge separately for certain costs and expenses as described in the enclosed statement.

For this engagement, HealthSouth will provide a \$100,000 retainer upon signature to be transmitted by wire to:

Citibank, F.S.B.  
1101 Pennsylvania Avenue, NW, Suite 1300  
Washington, D.C. 20004  
ABA Number: 254 070 116  
Account Number: 150 771 87  
Reference: Lanny J. Davis

The retainer will be held by the firm during the course of the engagement and will be returned to HealthSouth upon the payment of all outstanding fees and disbursements.

If these terms and conditions, including those set forth in the terms of engagement, meet with your approval, I would appreciate your acknowledging acceptance of both documents by signing and returning the enclosed copy of this letter. If you have any questions about these terms or would like to discuss them, please call me as soon as possible so as not to impede our commencing work on your behalf.

These terms and conditions will apply to any future work we undertake for you unless we send you a new letter reflecting different terms and conditions.

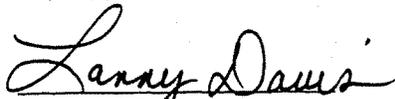
**PB 00139**

PATTON BOGGS LLP  
ATTORNEYS AT LAW

HealthSouth Engagement Letter  
September 23, 2002  
Page Three

We look forward to working with HealthSouth to achieve a successful result.

Very truly yours,

  
Lanny J. Davis

for PATTON BOGGS LLP

Enclosure

AGREED TO AND ACCEPTED:

By: \_\_\_\_\_  
Richard M. Scrushy  
Chairman, HealthSouth  
SIGNING ON BEHALF OF THE COMPANY

**Hirsch, Hal**

---

**From:** Gold, Neil  
**Sent:** Tuesday, October 01, 2002 12:46 PM  
**To:** Hirsch, Hal  
**Subject:** IMPORTANT

Did you agree to let Lanny see our work product? Won't that compromise our investigation since he represents Scrushy. Please call David or me.

-----  
Neil Gold  
Phone: 212-318-3022  
Fax: 212-318-3400  
ngold@fulbright.com

Tab 47

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 010495

Hirsch, Hal

---

**From:** Depke, John  
**Sent:** Tuesday, October 01, 2002 6:41 PM  
**To:** Unger, Peter; Hirsch, Hal  
**Subject:** More shreds

Found outside legal and obviously very recent. More emails having July dates. Barrack spoke to Horton.

Tab 48

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 010496

CONFIDENTIAL  
TREATMENT REQUESTED

**HEALTHSOUTH Corporation**  
**MEETING OF THE BOARD OF DIRECTORS**  
**OCTOBER 1, 2002**  
**MINUTES .                      Tab 49**

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 1, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrusby, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Charles W. Newhall III, Larry D. Striplin, Jr., Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, Eric R. Hanson of U.S. Strategies, Michael Rediker of Haskell Slaughter Young & Rediker, Hal M. Hirsch of Fulbright & Jaworski, L.L.P., and Lanny J. Davis of Patton Boggs, LLP.

Richard M. Scrusby acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrusby at 12:25 p.m. C.D.T.

**Surgery Divestiture Update**

Mr. Owens advised the Board that management gave a high-level presentation to a group of interested buyers in New York in a meeting arranged by the bankers. The Corporation is gauging the level of interest and will provide additional information to serious buyers. Mr. Owens stated that

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the Corporation had not abandoned the split/spin strategy of the surgery division, but that it should evaluate other options if any develop.

#### **Lawsuit Update**

Mr. Rediker provided the Board with an update on the various shareholder lawsuits. He advised that the Corporation filed answers in 14 cases on September 30.

#### **Fulbright & Jaworski Update**

Mr. Hirsch presented to the Board a preliminary report of Fulbright & Jaworski's review of the Corporation's disclosures and related events surrounding CMS Transmittal 1753. Mr. Hirsch read a proposed letter to the Board, a copy of which is incorporated into these minutes. Mr. Hirsch then entertained questions from the Board.

Mr. Davis at that point added that he had agreed to undertake the assignment with HEALTHSOUTH only with the understanding that he must have complete transparency. Mr. Davis stated that he felt the Corporation had been completely open and transparent and at this point in time Fulbright & Jaworski had found nothing to indicate that Mr. Scrusy knew anything about the impact of CMS Transmittal 1753 at the time of his stock transactions in May and July 2002.

#### **Appointment of Corporate Governance Committee**

Mr. Scrusy proposed that the Board establish a Corporate Governance Committee to be made up of three outside Directors plus a minimum of two reputable independent advisors who are not members of the Board. The Directors serving on the Committee would make recommendations for such independent advisors, to be submitted to the full Board for approval. After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Striplin, the following resolutions were unanimously adopted:

RESOLVED, that the following persons are hereby appointed to the Corporate Governance Committee of the Board of Directors, each to serve until the next Annual Meeting of the Board of Directors of this Corporation and until his

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successor is duly appointed and qualified, or until his earlier death, resignation or removal:

Robert P. May  
Jon F. Hanson  
John S. Chamberlin

RESOLVED, that the foregoing members of the Corporate Governance Committee shall consider and recommend to the Board of Directors of the Corporation for approval at least two independent persons who are not Directors, officers or employees of the Corporation to serve on the Corporate Governance Committee as special advisors.

**Special Litigation Committee**

Mr. Striplin advised the Board that he had resigned as Chairman of the Special Litigation Committee and that Mr. May had been elected to replace him. Mr. May then reported to the Board that the Special Litigation Committee had engaged Balch & Bingham LLP to serve as its counsel, would meet with counsel, and would keep the Board informed through routine reports to the Board.

**Compensation Committee**

Mr. Striplin advised the Board that the Compensation Committee recommended the following compensation for the Special Litigation Committee: \$25,000 per year retainer, \$2,500 for in-person Committee meetings and \$1,000 for telephone Committee meetings.

Upon motion duly made by Mr. Striplin and seconded by Mr. Newhall, the following resolution was unanimously adopted:

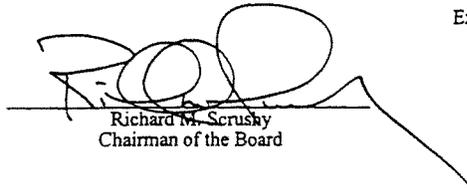
RESOLVED, that compensation for the Special Litigation Committee of the Board of Directors is hereby set at a retainer of \$25,000 per year, plus a fee of \$2,500 for in-person meetings of the Special Litigation Committee and \$1,000 for telephonic meetings of the Special Litigation Committee.

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**Investor Relations Update**

Mr. McVay advised the Board that the Corporation was in the process of reviewing its investor relations function with the objective of improving effectiveness, particularly with the major 100 investors. Mr. McVay stated that he would provide the board with more information at a subsequent Board meeting.

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrusky  
Chairman of the Board



---

Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

**Melendez, Madelene**

**From:** Davis, Lanny  
**Sent:** Wednesday, October 02, 2002 9:33 AM  
**To:** 'hhirsch@fulbright.com'  
**Subject:** Personal Tab 50

Please go back to my previous personal email to you. You are my friend--and I admire you as a lawyer more than I can express.

I talked to Richard. Going forward, Richard and I want you plus an associate of your choice to be my co-counsel in everything I do on HealthSouth--on CMS review, corporate governance advice, and Peter and you on S.E.C. How about asking Kemp to serve on the Corp. Governance Committee.

Re current work, Richard agrees:

1. Complete Richard investigation with a reasonable timetable and estimated budget. We are not asking for definitive finding. Therefore preliminary can continue to be used to characterize your report.
2. Re the Company investigation: The emails and interviews FJ have showed us to date are sufficient to permit the Board to conclude that some management below Richard may have had reason to believe that the new CMS rule, if it was implemented unchanged, might have impact on Part A reimbursements to the Company. We will now look to the S.E.C. to investigate all these issues.

I truly appreciate our friendship, Hal. It is rare to feel this brotherly close for two guys this quickly. You know my flaws almost as well as Carlyn--and I know a few of yours.

Let's take care of each other here. As Bill Clinton once said to me at a moment of high stress, "non illegitimum corborandum" -- "Don't Let The Bastards Get You Down."

I will get you paid immediately--can you do invoiced thru Friday of this week, even if approximation? We'll wire asap.

Lanny

PS. Do you want me to send you email of just 1 and 2 above, plus thanks from Richard and Board in letter to you, that you can forward to colleagues? I'll call you later.

By the way, I do think we can use Fred as consultant on CMS issue.

PB 02036

**From:** Hervey, Jason  
**Sent:** Monday, October 7, 2002 3:29 PM  
**To:** Scrushy, Richard  
**Subject:** Fw: Re:

---

Tab 51

Hals response below.

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: Hervey, Jason <Jason.Hervey@healthsouth.com>  
To: 'hhirsch@fulbright.com' <hhirsch@fulbright.com>  
Sent: Mon Oct 07 14:28:49 2002  
Subject: Re:

I am in with RS now and he wanted me to ask you. I guess we just missed you....want a ride in the humvee?

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: Hirsch, Hal <hhirsch@fulbright.com>  
To: Hervey, Jason <Jason.Hervey@healthsouth.com>  
Sent: Mon Oct 07 14:23:06 2002  
Subject: Re:

This is not an exact science. What we did last time was cause the review respond to an artificial timetable without the best result. We will respond when you like or when we are complete. I suggest the latter which should be on or about a week from Friday. Could be less, could be more. Just as I discussed with RMS the other day.

-hnh  
Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
From: Hervey, Jason <Jason.Hervey@healthsouth.com>  
To: 'hhirsch@fulbright.com' <hhirsch@fulbright.com>  
Sent: Mon Oct 07 14:16:58 2002  
Subject: Re:

When you presented to us on oct 1st it was two weeks from then?  
-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----  
From: Hirsch, Hal <hhirsch@fulbright.com>  
To: Hervey, Jason <Jason.Hervey@healthsouth.com>  
Sent: Mon Oct 07 14:10:56 2002  
Subject: Re:

Next Friday - two weeks.  
-hnh  
Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----

From: Hervey, Jason <Jason.Hervey@healthsouth.com>

To: 'hhirsch@fulbright.com' <hhirsch@fulbright.com>

Sent: Mon Oct 07 14:06:04 2002

Subject:

Hello my friend. With RS and when is due date for rs report? This Friday or next?

-----  
Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

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in error, please notify me immediately by replying to this message and deleting it from your computer. Thank you.

(3)

OCT-11-02 15 36 FROM HAMPSHIRE MANAGEMENT ID: 9732679933

PAGE 4/7

Joel C. Gordon  
6403 East Valley Court  
Nashville, Tennessee 37205

C.C. Hirsch  
Punger  
Mary S.  
Adam G.

*Sent Via Facsimile and United Parcel Service*

October 8, 2002

Tab 52

Richard M. Scrusby  
HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

I am writing to address certain concerns that I continue to have following our recent board meetings. As you are aware, I called a meeting of the Corporate Compliance Committee on September 13, 2002, to consider appropriate actions by the Committee. At that meeting, it was the consensus of the Committee that the Committee conduct an investigation, through the engagement of independent counsel.

During that meeting, we determined to seek the view of Mr. Horton, the Company's corporate counsel, as to whether or not two firms recommended by members of the Committee, Wilmer, Cutler & Pickering and Kirkland and Ellis, had any conflict in assisting the Committee in conducting that inquiry. At that time, Mr. Horton stated his view that while he knew of no conflict, he believed that the Committee did not have the power to undertake such an investigation on its own and that it could not retain outside advisors without authorization from the full board of directors. Both I and my counsel disagreed with that view; however, in view of my desire that such an investigation be commenced promptly, I agreed to consult with the other members of the board of directors who were not members of management to determine if they concurred with the Committee's decision. No objections were raised by those members with whom I spoke.

At a meeting of the board of directors held on September 17, 2002, I gave a report to the board regarding the meeting of the Corporate Compliance Committee and our desired course of action. I suggested that the Committee be authorized to retain Wilmer, Cutler & Pickering to assist in conducting the inquiry. One of the other members of the Committee suggested that Fulbright & Jaworski be engaged, and I stated that I did not have a problem with that firm. However, when a member of that firm joined the board meeting by conference call, we were informed that he had been working on this matter for the preceding two days. He also expressed his preliminary views about the likely positive results of the investigation.

PB 00719

118

404 000 70 31 000

At our most recent board meeting, I learned that the Company had engaged Fulbright & Jaworski to conduct a review and that it was not to be an independent investigation. The purpose of the Committee's recommendation was to conduct an independent investigation, i.e. one outside the control of management. I might add that I understand Fulbright & Jaworski to be an excellent firm with a fine reputation. My concern goes to the independence of the inquiry.

As I stated to my fellow members of the Corporate Compliance Committee, I believe that it is appropriate to undertake an objective review independent of management to determine if the Company's management acted in compliance with disclosure requirements and if any of the Company's executives who had made sales or other dispositions of Company securities have complied with applicable laws and regulations and with the Company's compliance policies and procedures. I sincerely hope that there has been full compliance but, as a director and Chair of the Corporate Compliance Committee, I need to assure myself that these issues are fully explored and resolved. To accomplish this, I must request the following:

1. As Chairman of the Corporate Compliance Committee, I expect to receive regular updates on the status and results of the Fulbright investigation. I request that the Committee be authorized to engage counsel either to conduct a separate independent investigation or at least to have access to the work performed by Fulbright. Accordingly, I request that you direct Fulbright & Jaworski to consult with that counsel as to their investigative plan. I also expect Fulbright & Jaworski to provide that counsel ongoing access to the information obtained in their investigation.
2. In accordance with the Company's by-laws, notice of any action to be taken at a board meeting should accompany the notice of the time and place of the meeting. I am distressed that members of the board were asked to take actions on several fronts without prior notice of the subject matter thereof or any information about the proposed actions prior to the meeting. While I support the efforts to add additional independent members to the Company's board of directors, I am concerned that the procedures for nominating and electing Mr. Hanson and Mr. May to the board, and the information provided to the Board in that connection, were incomplete. Did the nominating committee of the board of directors consider his qualification and conduct their own review of his independence? Are there any relationships (including any charitable or political contributions) between Mr. Hanson or Mr. May and any of his affiliated entities and the Company or members of its senior management or any of their affiliated entities? Again, I endorse the idea of adding additional independent directors to the Company's board; however, I believe that the board should follow the good corporate governance practices in doing so and

PB 00720

look forward to reviewing the work of the new Corporate Governance Committee.

3. To the extent that actions are proposed to be taken by the Board of Directors, I would like to see the exact form of proposed resolutions for such actions as well as detailed information regarding the proposals at least 48 hours in advance of the Board meeting. We need appropriate time to review proposals and information regarding any management proposal.

*dec 7 BT*

4. I would like to see drafts of minutes of board meetings or committee meetings ~~within ten days after those meetings are held~~. I do not believe it is desirable to wait until the next meeting occurs and have the directors consider approval at the meeting without opportunity for prior review. To be certain my records are complete, please send me immediately all approved board and committee minutes from January 1, 2002 to date.

*usually follow board minutes*

*OK*

5. I understand that the SEC has given the Company notice of an investigation and the media has reported that the investigation focuses on accounting matters as well as trading activity. I also understand that the Company has engaged Patton and Boggs to represent it in connection with the investigation. This investigation is of obvious importance to the Company and I request the following information.

*unaware per letter*

a. a copy of the SEC notice of investigation and of any future letters or document requests or subpoenas from the SEC as well as any responses by the Company to those letters or requests;

*to the Bd*

b. a copy of the engagement letter of Patton and Boggs;

*under advis 7 comm*

*OK*

c. a written statement describing any verbal comments received from the staff of the SEC regarding the scope of matters under review by them, including whether the conduct of any individual, executive officer or director of the Company is a subject of any document or informational request;

d. confirmation that the Corporate Compliance Committee will receive copies of information provided to the SEC and that Patton and Boggs will keep the Committee informed regarding the status of the SEC investigation, including any change in the scope of their investigation or any additional issues identified for investigation by the staff of the SEC; and

*NO*

e. a copy of the Company's current document retention policy.

PB 00721

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

2550 M Street, NW  
Washington, DC 20037-1350  
202.457.6000

Facsimile 202.457.6315

**To:** Hal Hirsch  
**ATTN:** Allen Kadish  
**Fax Number:** 212.318.3400  
**Phone #:** 212.318.3105

---

**Total Pages**  
Including Cover: **Four**

---

**From:** **Maddie Melendez (Assistant to Lanny J. Davis)**  
**Sender's Direct Line:** 202.457.5226  
**Date:** October 15, 2002

**Comments:**

**Mr. Hirsch:**

**As per Lanny's request, please see attached document.  
Thank you.**

**Maddie**

ANCHORAGE  
DALLAS  
DENVER  
NORTHERN VIRGINIA  
SEATTLE  
WASHINGTON, D.C.

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**PB 00722**

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CONNECTION TEL	21231834000134760100
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CONNECTION ID	
ST. TIME	10/15 15:27
USAGE T	02'06
PGS. SENT	4
RESULT	OK

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2550 M Street, NW  
Washington, DC 20037-1350  
202.457.6000

Facsimile 202.457.6315

<b>To:</b>	Hal Hirsch
<b>ATTN:</b>	Allen Kadish
<b>Fax Number:</b>	212.318.3400
<b>Phone #:</b>	212:318.3105
<b>Total Pages</b>	
Including Cover:	<b>Four</b>
<b>From:</b>	<b>Maddie Melendez (Assistant to Lanny J. Davis)</b>
<b>Sender's Direct Line:</b>	202.457.5226
<b>Date:</b>	October 15, 2002

**Comments:**

**Mr. Hirsch:**

**As per Lanny's request, please see attached document.  
Thank you.**

**Maddie**

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**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

2550 M Street, NW  
Washington, DC 20037-1350  
202.457.6000

Facsimile 202.457.6315

**To:** Peter Unger  
**ATTN:** Doris  
**Fax Number:** 202.662.4643  
**Phone #:**

---

**Total Pages**  
Including Cover: **Four**

---

**From:** **Maddie Melendez (Assistant to Lanny J. Davis)**  
**Sender's Direct Line:** 202.457.5226  
**Date:** October 15, 2002

**Comments:**

**Mr. Unger:**

**As per Lanny's request, please see attached document.  
Thank you**

**Maddie**

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**PB 00724**

10/15/2002 15:21 FAX

001

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*** TX REPORT ***
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TX/RX NO          0562
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CONNECTION ID
ST. TIME         10/15 15:19
USAGE T         02'09
PGS. SENT        4
RESULT           OK

```

**PATTON BOGGS LLP**  
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2550 M Street, NW  
Washington, DC 20037-1850  
202.457.6000

Facsimile 202.457.6315

**To:** Peter Unger  
**ATTN:** Doris  
**Fax Number:** 202.662.4643  
**Phone #:**

**Total Pages**  
**Including Cover: Four**

**From:** Maddie Melendez (Assistant to  
Lanny J. Davis)

**Sender's Direct Line:** 202.457.5226

**Date:** October 15, 2002

**Comments:**

**Mr. Unger:**

**As per Lanny's request, please see attached document.  
Thank you**

**Maddie**

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PB 00725

**Veneracion, Susana**

---

**From:** Davis, Lanny Tab 53  
**Sent:** Sunday, October 13, 2002 6:14 PM  
**To:** Richard M. Scrushy (E-mail)  
**Cc:** Michael Deaver (E-mail); Sheila Tate (E-mail); Eric R. Hanson (E-mail); Jason R. Hervey (E-mail); O'Connor, Eileen; Hollis Rafkin-Sax (E-mail); Hal Hirsch (E-mail); Melendez, Madelene; Heidi Schwartz (E-mail)  
**Subject:** F&J Final Report--Privileged and Confidential

This message is Subject to Attorney Work Product Privilege and is Confidential

Richard --  
copy to Hal:

Sunday, late afternoon:

Hal Hirsch just told me that he "plans" on completion of the "final" F&J Report ("Final Report") -- pertaining to the first time Richard Scrushy knew of the potential material impact of the CMS rule change on the Company -- by this Friday, October 18. Thus, the Final Report can "likely" be transmitted to the SEC on that day or by Monday, October 21. Please note that there is always a possibility that there will be a slippage of a day or two or three, but Hal will do his best to adhere to that schedule.

Hal also said he would recommend to the senior management of F&J that the Report include an "Executive Summary," signed by him, and that such Executive Summary, together with the Final Report, will be capable of public release by the Company, subject to the Company's independent judgment to do so, after the Executive Summary and Report have been sent to the SEC. I assured Hal that neither he nor any of his colleagues at F&J need to talk to or accept calls from the press when the Executive Summary and Final Report are publicly released, as I told him both would be by the Company.

For planning purposes our colleagues at Edelman and Powell Tate can plan on Tuesday am, October 22, as the public release date of both the Executive Summary and the Full Report, although it is possible that may slip a day or two. We should be able to make a final decision, in consultation with Hal, on the timing of everything no later than Thursday, October 17.

Hal also told me that the Executive Summary and Final Report will also include the conclusions of the FTI team regarding the accuracy of the \$175 million estimated reduction in earnings projections that was included in the August 27, 2002 press release. This could be viewed by the Street as very significant, so we should be sure the details of that analysis are able to be fully explained to key analysts and shareholders.

If you or anyone copied on this email have any questions regarding the above, please call me and leave a message on voicemail (202-457-6490), since my Blackberry is on the blink and I am frequently late on reading emails. Indeed, generally speaking, please leave me voicemail messages if they are important and don't depend on email. Thanks.

**Hirsch, Hal**

**From:** Kaplan, Carl  
**Sent:** Tuesday, October 15, 2002 2:48 PM  
**To:** Hirsch, Hal  
**Subject:** RE: Final Revised Gordon Letter

**Tab 54**

why isn't this an item to be taken up with the whole board why wouldn't gordon's letter be circulated and let the board discuss and vote on it why is it a decision of the chairman i'd kill the letter entirely and let the board deal with it

-----Original Message-----

**From:** Hirsch, Hal  
**Sent:** Tuesday, October 15, 2002 2:37 PM  
**To:** Unger, Peter; Beckler, Richard; Kaplan, Carl; Gold, Neil  
**Subject:** RE: Final Revised Gordon Letter

I do not like it. Hence, I suggest that we have absolutely NOTHING to do with it and let them do whatever they like. We must advise that we are not opining on the letter in any way. It is very much akin to a press release and may be used in that manner.  
-hmh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
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hhirsch@fulbright.com

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-----Original Message-----

**From:** Unger, Peter  
**Sent:** Tuesday, October 15, 2002 2:27 PM  
**To:** Hirsch, Hal; Beckler, Richard; Kaplan, Carl; Gold, Neil  
**Subject:** FW: Final Revised Gordon Letter

This letter is obviously unacceptable. Hal, how do you wish to proceed ?

-----Original Message-----

**From:** Davis, Lanny [mailto:LDavis@PattonBoggs.com]  
**Sent:** Tuesday, October 15, 2002 10:10 AM  
**To:** 'bill.horton@healthsouth.com'; Melendez, Madelene  
**Cc:** Sjoquist, Mary; 'punger@fulbright.com'  
**Subject:** Fw: Final Revised Gordon Letter

Please call Maddie with final changes. 202-457-5226. Maddie--you can fax ex and fax to Gordon possible as soon as you've heard from Bill. Also check with Mary and Peter U.

-----Original Message-----

**From:** Horton, Bill <Bill.Horton@healthsouth.com>  
**To:** 'Davis, Lanny' <LDavis@PattonBoggs.com>  
**CC:** Scrusby, Richard <rscrusby@healthsouth.com>

**CONFIDENTIAL TREATMENT REQUESTED**  
By Dechert LLP on behalf of its client

FJ 010708

Sent: Tue Oct 15 10:01:17 2002  
Subject: RE: Final Revised Gordon Letter

I have marked some additional minor changes/corrections in the attached. I will forward the clean text to Richard for his review.

Bill

-----Original Message-----  
From: Davis, Lanny [mailto:LDavis@PattonBoggs.com]  
Sent: Tuesday, October 15, 2002 7:27 AM  
To: Horton, Bill; Scrusby, Richard  
Cc: Davis, Lanny  
Subject: Final Revised Gordon Letter

Please call me -- and/or Maddie (202-457-5226) -- with any final comments. I have asked Hal and Peter Unger to comment as well. Bill -- I need a clean version of the letter sent to Richard.

<<RevisedScrusbyGordonLtr(version1)>>

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By Dechert LLP on behalf of its client

FJ 010709

10/15/2002 17:36 FAX

002/004



Tab 55

2550 M Street, NW  
 Washington, DC 20037-1350  
 202-457-8000  
 Facsimile 202-457-5315  
 www.pattonboggs.com

**VIA FACSIMILE NO.: (615) 298-5641 & FEDERAL EXPRESS**

October 15, 2002

Mr. Joel C. Gordon  
 6408 East Valley Court  
 Nashville Tennessee 37205

**Re: Your Letter of October 8, 2002 to Richard M. Scrusby**

Dear Mr. Gordon:

I have been asked to respond to your letter of October 8, 2002 to Richard M. Scrusby, Chairman of HealthSouth Corporation. I understand you have sent a separate letter to one or more members of the Board enclosing a copy of your letter to Mr. Scrusby.

If you are already represented personally by counsel regarding this matter, please pass this letter on to him/her and ask him/her to call me whenever practicable. When I use the word "you" in this letter, I am referring to you and/or your counsel.

For your convenience, in communicating my response, I will refer to each of your requests by the same numbering you used in your October 8 letter.

1. As Chair of the Corporate Compliance Committee, you have asked for the Company to authorize the CCC to retain its own counsel, either to conduct a separate investigation of the same matters currently under investigation by Fulbright & Jaworksi ("F&J"), or at least to have access to their completed and ongoing work. I am assuming that by this you mean that the Company should pay for such separate counsel. Respectfully, in my judgment, the Company should reject your request as an unnecessary use of corporate resources.

To remind you, at its September 13, 2002, meeting, the Board of Directors of HealthSouth determined that F&J should be retained to conduct an "outside review" pertaining to various issues in connection with the Company's press release of August 27, 2002, including when Mr. Scrusby first learned of the potential material effect on the Company of the CMS rule change, apparently first transmitted on May 17, 2002. Also at that Board meeting, as you know, the Board authorized the Special Litigation Committee to retain counsel (and the Committee has retained the firm of Balch & Bingham of Birmingham, Alabama) to conduct a separate investigation with respect to issues raised in stockholder derivative suits filed in Alabama (and subsequently in Delaware).

Washington DC | Northern Virginia | Dallas | Denver | Boulder | Anchorage

OCT-15-2002 17:00

**HHEC 408-1411**  
 Confidential Treatment

96%

P.02

10/15/2002 17:36 FAX

003/004

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

In an earlier paragraph of your letter, you imply that the F&J outside review may not be based on F&J's "independent" judgments as to the facts. This suggestion is without foundation. It is my understanding that the F&J investigation, employing more than a dozen attorneys and financial experts, has already encompassed nearly two dozen personal interviews of senior management and key employees, as well as the careful review of several hundred thousand pages of emails and other internal documents.

You imply that this extensive F&J review may not be "outside the control of management." This is not correct. In fact, from the outset Company management committed to the F&J team that it had total independent judgment in the conduct of its review. You and your attorneys can confirm with F&J that that commitment has been and continues to be strictly maintained.

Of course, you have the right to retain your own personal attorneys at your expense. Regarding their access to the F&J current and future work product, I see no problem with that request, subject to appropriate safeguards to protect the privileged nature of the information until such time as the Board elects to make it public. You and all the Board have already heard the full F&J preliminary report read to you during the October 1, 2002, Board meeting. You and other Board members will have access to the final report at the time it is issued to the Board.

2. I am referring your suggestions and questions regarding procedural and Board governance matters to the Company's General Counsel, Mr. William Horton. I also encourage you to raise them with the full Board at its next meeting and with Mr. May, as Chair of the Special Corporate Governance Committee.

Regarding your other points, it is my understanding that the resumes of Mr. Hanson and Mr. May were sent out to all Board members prior to the meetings at which they were elected, and that there were no votes against their election. It is my understanding that you did not raise any of the questions or concerns during those Board meetings regarding their backgrounds or qualifications. You are certainly free to take up these and any other questions raised in your letter with them directly or at the next Board meeting.

Regarding your reference to the need for "good corporate practices" and notice procedures, I would encourage you to propose those to the full Board for discussion and consideration. As you know, at the October 1 Board meeting, Mr. Scrusby took an important initiative on the issue of corporate governance. He nominated Mr. Robert May as Chair and two other Board members to serve on a Special Corporate Governance Committee. Mr. Scrusby's initiative was unanimously endorsed by the Board, yourself included.

I know that your suggestions and concerns on these corporate governance issues are and will be appreciated and welcomed by Mr. Scrusby and Mr. May, as well as the other directors.

3. Please refer to the first two sentences of item 2, above.

**HHEC 408-1412**  
Confidential Treatment  
Requested by HealthSouth Corp.

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

4. Please refer to the first two sentences of item 2, above. I have passed your request for copies of all previously approved minutes on to Brad Hale.

5. a. I attach a copy of the SEC notice of investigation. There has been no written response on behalf of the Company, although the Company's counsel has been in touch with the SEC to establish a protocol for production of the requested documents.

Regarding making available future correspondence to and from the SEC, you and the other Board members are always welcome to see such correspondence.

b. I have no objection to your reviewing the Patton Boggs engagement letter, but that is a decision I defer to Mr. Horton.

c. I spoke to the SEC officials after receipt of their investigation and they made no verbal comments indicating that the scope of the matters under review by them was any different than the contents of their notice of investigation.

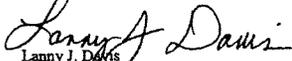
d. I refer to Mr. Horton your request that the CCC be provided with copies of all "information" provided to the SEC as well as any change in the scope of their investigation or any additional issues identified by staff. If such a request were granted to the CCC, it arguably must also be granted to any individual Board member. There are obvious logistical, practical, and possible SEC confidentiality concerns with agreeing ahead of time to such a blanket request.

Regarding your request for updates concerning the investigation, I see no reason why this cannot be done within the constraints of confidentiality consistent with an SEC ongoing investigation - again, with the understanding that there arguably is no basis for distinguishing members of the CCC from other Board members.

e. Mr. Horton will respond to your request concerning the Company's present document retention policy.

I hope this letter has been responsive to yours. I look forward to discussing each of these points with you or your personal attorney - either myself or in conjunction with Mr. Horton.

Sincerely,

  
Lanny J. Davis  
Counsel to HealthSouth Corporation

**HHEC 408-1413**  
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Requested by HealthSouth Corp.

CONFIDENTIAL  
TREATMENT REQUESTED

**HEALTHSOUTH Corporation**  
**MEETING OF THE BOARD OF DIRECTORS**  
**OCTOBER 15, 2002**  
**MINUTES** Tab 56

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 15, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrushy, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Charles W. Newhall III, Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, Malcolm E. McVay, Executive Vice President and Chief Financial Officer of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, and Lanny J. Davis and Mary Sjoquist of Patton Boggs, LLP. Present with Mr. Scrushy in the Board Room were Messrs. Owens, May, Hale, McVay, Horton and Hervey. All others participated via a telephonic connection whereby everyone could freely hear and speak to one another.

Richard M. Scrushy acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrushy at 11:00 a.m. C.D.T.

**Media Relations Update**

Mr. Davis discussed with the Board recent media coverage on Mr. Striplin and his independence as a Director. Mr. Davis stated that the firestorm had died down somewhat in the past

HHEC 18-02310

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few days and the Corporation's current strategy was not to talk to the press with stories until we had proactive news to report with a focus on profitability and successes.

#### **Investor Relations Plan**

Messrs. McVay and Hervey reviewed with the Board a written plan developed by the Treasury and Media Relations Departments to enhance investor relations.

#### **Special Litigation Committee Report**

Mr. May presented to the Board a report of activities of the Special Litigation Committee. He reported that the Committee had met twice to date, with one meeting including attorneys from Balch & Bingham, who were retained to represent the Committee. The Committee also met with representatives of Fulbright & Jaworski to assure that all documents are shared with the Committee and Balch & Bingham. Mr. May advised the Board that the Committee had received information on all litigation and would provide the Board with a summary of all cases being reviewed by the Committee.

#### **Corporate Governance Committee Report**

Mr. May reported to the Board that the Committee was in the process of developing a charter for the Corporate Governance Committee, and stated that when the draft was complete he would send a copy to each Board member for his review. Mr. May stated that he anticipated that it would take 90 days to complete all recommendations and that he would have a timeline developed within the next week. In addition to the charter, the Committee is working on an Insider Trading Policy and is reviewing the need to develop a formal Board of Directors Administrative Guideline to include assessment of Directors and executive management.

Mr. May also provided the Board with a status report on outside Committee members being considered to serve on the Corporate Governance Committee.

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**Other Committee Matters**

Mr. Scrushy advised the Board of Mr. Striplin's resignation from the Special Litigation Committee and his resignation as Chairman of the Compensation Committee. Mr. Scrushy then recommended Mr. May be named to serve on the Compensation Committee and to serve as its Chairperson.

After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Gordon, the following resolutions were unanimously adopted:

RESOLVED, that this Board of Directors accepts the resignation of Larry D. Striplin, Jr. from the Special Litigation Committee and his resignation as Chairman of the Compensation Committee of this Board of Directors, commends Mr. Striplin for his service in such roles and looks forward to his continuing service as a member of the Compensation Committee.

RESOLVED, that Robert P. May is hereby appointed to the Compensation Committee as its Chairman, to serve until the next Annual Meeting of the Board of Directors of this Corporation and until his successor is duly appointed and qualified, or until earlier death, resignation or removal.

**Surgery Spin/Split**

Mr. Scrushy recommended to the Board that the Corporation suspend the transaction to spin/split the surgery division, and read a draft press release which outlined the reasons for the suspension of that transaction. After discussion, upon motion duly made by Mr. Gordon and seconded by Dr. Watkins, the following resolution was unanimously adopted:

RESOLVED, that the Board of Directors hereby suspends its previously preliminary approval of the plan for a tax-free separation of the Corporation's surgery center division until further action by the Board of Directors.

Mr. Scrushy advised the Board that the Corporation would continue to assess and present to the Board any legitimate offers for divestiture of surgery facilities.

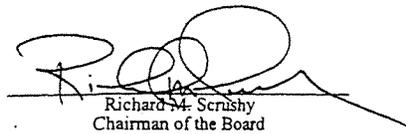
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**Other Business**

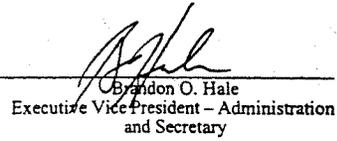
Mr. Scrusby updated the Board on meetings to take place with Institutional Shareholder Services on October 16 and with Herbert Denton of Providence Capital in New York on October 17.

Mr. Scrusby advised the Board that the Board retreat scheduled to be held in November in Palm Beach had been cancelled.

There being no further business to transact, the Meeting was adjourned.



Richard M. Scrusby  
Chairman of the Board



Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

**Hirsch, Hal**

---

**From:** Davis, Lanny [LDavis@PattonBoggs.com]  
**Sent:** Thursday, October 17, 2002 8:27 PM  
**To:** 'hhirsch@fulbright.com'  
**Subject:** Call or page me. Denton meeting went very well!!!!

Can I get rough draft tomorrow please? You promised I would not have to wait any longer than that. Need more than one day to register concerns. Let's talk early in am. Hope all is well. Understand from Owens that he never reads emails.  
Best,

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Tab 57

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By Dechert LLP on behalf of its client

FJ 009864

706

**From:** Hirsch, Hal <hhirsch@fulbright.com>  
**Sent:** Friday, October 18, 2002 9:07 AM  
**To:** Horton, Bill Tab 58  
**Cc:** Beckler, Richard, Kaplan, Carl  
**Subject:** Re: Report

---

Morning:  
I am to begin reviewing the draft Report today with submission to the Board on Tuesday. I have already heard Lanny's views this morning. I will give you a preview as appropriate. I continue my reticence that regardless of the statements concerning RMS it will leave open and troubling questions about the Transmittal and HS, as the HS/CMS review will not be completed for some time to come. Not that it is my provence, but since you inquire, I am very displeased with the draft press release as it seems not to improve any issues surrounding HS. I will call near noon as I free up.  
-hnh  
Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
From: Horton, Bill <Bill.Horton@healthsouth.com>  
To: Hal M. Hirsch (E-mail) <hhirsch@fulbright.com>  
Sent: Thu Oct 17 23:37:31 2002  
Subject: Report

What's the latest timing on the report presentation? I am scheduled for some travel next week, and want to make sure I'm on top of the situation.

Also, I remain interested in your reaction to the Powell Tate media proposal.

I appreciated your other offer(s) today, and will be back to you shortly.

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**Hirsch, Hal**

---

**From:** Newman, Marcia  
**Sent:** Friday, October 18, 2002 2:28 PM  
**To:** Hirsch, Hal  
**Subject:** Lanny Davis

Maddie called with the following message: (1) Whatever he said or did was in your best interest and for your sake, and he hopes you're not mad at him and (2) regardless of whether it is a final draft, please fax it to him tonight at home: 301-963-8733.

Tab 59

**CONFIDENTIAL TREATMENT REQUESTED**  
**By Dechert LLP on behalf of its client**

**FJ 009384**

**Hirsch, Hal**

**From:** Hirsch, Hal  
**it:** Saturday, October 19, 2002 6:58 PM  
**to:** 'LDavis@PattonBoggs.com'  
**Subject:** Re: HS Report Tab 60

Lanny:

Call now if you like. I have been prohibited from releasing a draft copy of the HS Fulbright Report. I have fought and won the opportunity for you or your associate to read it at Fulbright tomorrow as early as you like. If you like otherwise, I will read it to you and discuss it with you on the phone in the morning instead. I will not get the penultimate draft until midnight at the earliest. The Report is on target with our discussions.

-hnh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
 (212) 318-3400 (fax)  
 hhirsch@fulbright.com

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---Original Message----

**From:** Davis, Lanny <LDavis@PattonBoggs.com>  
**To:** 'hhirsch@fulbright.com' <hhirsch@fulbright.com>  
**Sent:** Sat Oct 19 17:47:08 2002  
**Subject:** Re:

TY. Will return from Carolyn's Georgetown Law reunion at 9 pm. Fax num is 301-963-8733.

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**By Dechert LLP on behalf of its client**

FJ 009897

Hirsch, Hal

---

**From:** Hirsch, Hal  
**Sent:** Saturday, October 19, 2002 7:14 PM  
**To:** 'LDavis@PattonBoggs.com'  
**Subject:** Re: HS Report

Call in the morning when you wake up and we can go over it line by line on the phone.

-hnh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

Tab 61

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-----Original Message-----

**From:** Davis, Lanny <LDavis@PattonBoggs.com>  
**To:** 'hhirsch@fulbright.com' <hhirsch@fulbright.com>  
**Sent:** Sat Oct 19 18:06:19 2002  
**Subject:** Re: HS Report

Can't go to Fulbright in am. What about home fax? 301-963-8733. I will call you as we head to reunion.

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By Dechert LLP on behalf of its client

FJ 009903

**Hirsch, Hal**

**From:** Galant, Felice  
**Sent:** Saturday, October 19, 2002 8:32 PM  
**To:** Hirsch, Hal  
**Subject:** RE: One more thing

Spoke to Neil. He wants us to ask Scrusby about the July 8, 2002 Monday morning meeting, before we characterize whether or not he heard it and didn't understand it or was doing something else, etc. As for Eric, he wants us to ask what he told Scrusby prior to August 6 about the transmittal or the issue generally.

-----Original Message-----  
**From:** Hirsch, Hal  
**Sent:** Saturday, October 19, 2002 8:20 PM  
**To:** Galant, Felice  
**Subject:** Re: One more thing

Tab 62

Why? And when?  
-hmh  
Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
**From:** Galant, Felice <fgalant@fulbright.com>  
**To:** Hirsch, Hal <hhirsch@fulbright.com>  
**Sent:** Sat Oct 19 19:13:38 2002  
**Subject:** FW: One more thing

-----Original Message-----  
**From:** Gold, Neil  
**Sent:** Saturday, October 19, 2002 8:12 PM  
**To:** Galant, Felice  
**Subject:** Re: One more thing

Schedule those interviews

-----  
Neil Gold  
Phone: 212-318-3022  
Fax: 212-318-3400  
ngold@fulbright.com

-----Original Message-----  
**From:** Galant, Felice <fgalant@fulbright.com>  
**To:** Dowdell, Tom <tdowdell@fulbright.com>; Walker, Joseph <jwalker@fulbright.com>; deButts, Robert <rdebutts@fulbright.com>; Beckler, Richard <rbeckler@fulbright.com>; Unger, Peter <punger@fulbright.com>; Depke, John <jdepke@fulbright.com>; Barrack, David L.

**CONFIDENTIAL TREATMENT REQUESTED**  
**By Dechert LLP on behalf of its client**

FJ 009911

<dbarrack@fulbright.com>; Gold, Neil <ngold@fulbright.com>  
Sent: Sat Oct 19 17:52:57 2002  
Subject: FW: One more thing

fyi  
-----Original Message-----  
From: Hirsch, Hal  
Sent: Saturday, October 19, 2002 6:48 PM  
To: Galant, Felice  
Subject: Re: One more thing

Correct, unless someone thinks it necessary or appropriate.  
-hnh  
Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
From: Galant, Felice <fgalant@fulbright.com>  
To: Hirsch, Hal <hhirsch@fulbright.com>  
Sent: Sat Oct 19 17:45:47 2002  
Subject: One more thing

Hal,

I just want to confirm, are we not re-interviewing Scrusby and not interviewing Eric Hanson before issuing the report to the Board and co.?

Felice

**Hirsch, Hal**

**From:** Hirsch, Hal  
**Sent:** Sunday, October 20, 2002 10:53 AM  
**To:** 'Bill.Horton@healthsouth.com'  
**Subject:** Re: HS Fulbright Report

In the process right now and he is happy, so far.

-hnh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
 (212) 318-3400 (fax)  
 hhirsch@fulbright.com

Tab 63

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-----Original Message-----

**From:** Horton, Bill <Bill.Horton@healthsouth.com>  
**To:** 'Hirsch, Hal' <hhirsch@fulbright.com>  
**Sent:** Sat Oct 19 21:14:15 2002  
**Subject:** RE: HS Fulbright Report

Please make arrangements with Lanny to review the draft. Thanks.

Bill

William W. Horton  
 Executive Vice President and Corporate Counsel  
 HEALTHSOUTH Corporation  
 One HealthSouth Parkway  
 Birmingham, AL 35243  
 Telephone (205) 969-4977  
 Facsimile (205) 969-4730  
 bill.horton@healthsouth.com

-----Original Message-----

**From:** Hirsch, Hal [mailto:hhirsch@fulbright.com]  
**Sent:** Saturday, October 19, 2002 6:06 PM  
**To:** Horton, Bill  
**Subject:** HS Fulbright Report

Bill:

We have just finished the penultimate draft of the Report due to the Board on Tuesday. I expect a copy near midnight. Lanny Davis has requested to see and comment on the Report in advance. Fulbright will not allow me to transmit a draft but, with your authority as General Counsel, I can allow him to read it our office tomorrow morning or read it to him. I therefor request your authority to do so. Please advise at your first opportunity. Thank you.

-hnh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue

CONFIDENTIAL TREATMENT REQUESTED  
 By Dechert LLP on behalf of its client

FJ 010738

New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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**Hirsch, Hal**

---

**From:** Hirsch, Hal  
**Sent:** Sunday, October 20, 2002 12:00 PM  
**To:** Dowdell, Tom  
**Subject:** I am on with Lanny - all is well I need 15 minutes

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

Tab 64

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**CONFIDENTIAL TREATMENT REQUESTED**  
By Dechert LLP on behalf of its client

FJ 009429

**From:** Hirsch, Hal <hhirsch@fulbright.com>  
**Sent:** Monday, October 21, 2002 6:16 AM  
**To:** LDavis@PattonBoggs.com, AGoldberg@PattonBoggs.com, ehanson@usstrategies.com, Hervey, Jason, rpmay@aol.com, bobmay9788@msn.com, jlpowell@webershandwick.com, state@webershandwick.com, hschwartz@webershandwick.com, michael.deaver@edelman.com, hollis.raffin-sax@edelman.com, Scrushy, Richard  
**Subject:** Re: Urgent--Privileged Attorney Client and Work Product

---

The document will be presented to the Board on Tuesday morning.

-hnh  
 Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
 (212) 318-3400 (fax)  
 hhirsch@fulbright.com

Tab 65

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-----Original Message-----

From: Davis, Lanny <LDavis@PattonBoggs.com>  
 To: 'hhirsch@fulbright.com' <hhirsch@fulbright.com>; Goldberg, Adam <AGoldberg@PattonBoggs.com>; 'ehanson@usstrategies.com' <ehanson@usstrategies.com>; 'jason.hervey@healthsouth.com' <jason.hervey@healthsouth.com>; 'rpmay@aol.com' <rpmay@aol.com>; 'bobmay9788@msn.com' <bobmay9788@msn.com>; 'jlpowell@webershandwick.com' <jlpowell@webershandwick.com>; 'state@webershandwick.com' <state@webershandwick.com>; 'hschwartz@webershandwick.com' <hschwartz@webershandwick.com>; 'michael.deaver@edelman.com' <michael.deaver@edelman.com>; 'hollis.raffin-sax@edelman.com' <hollis.raffin-sax@edelman.com>; 'rscrushy@healthsouth.com' <rscrushy@healthsouth.com>  
 Sent: Sun Oct 20 23:00:25 2002  
 Subject: Urgent--Privileged Attorney Client and Work Product

Talked to RS for one hour late tonite and conferred with Bob May too. RS

now  
leans in favor of public release of complete Fulbright Report on Wed am  
after presentation to Board on Tues. Bob May agrees.

This is of course subject to everyone on this email list hearing the  
report  
read in full by Hal some time on Monday--and perhaps reading along with  
Hal  
if he can email us penultimate draft, as he has indicated to me.

In my opinion, after discussion with most of you Sun nite, just  
releasing  
the first section on methodology and just last paragraph clearing RS  
will  
lack context and credibility. I also believe once everyone hears the  
full  
factual chronology in the Fulbright Report, all will conclude that it  
needs  
to be available to shareholders and the public, and that it provides a  
critical basis for accountability and remediation by the  
Board--something  
shareholders are demanding and the press is waiting for. Not releasing  
it  
also will look like a pullback on our prior commitment to  
transparency--with  
little credible explanation.

Adam--please set up conf call with all on the above email list so that  
Hal  
can read the report to all first thing in am. I will be out of town and  
returning to DC at 2 pm EST. I propose a second conf call at 4 pm EST  
to  
reach final judgments on strategy.

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call  
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Also, we would appreciate your forwarding the message back to us and  
deleting it from your system. Thank you.

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<http://www.pattonboggs.com>.

Hirsch, Hal

---

**From:** Davis, Lanny [LDavis@PattonBoggs.com]  
**Sent:** Monday, October 21, 2002 8:09 AM  
**Subject:** Re: Urgent--Privieged Attorney Client and Work Product

If it is in final form--and that would be understanding BEFORE you read-- advance reading has no impact on Fulbright credibility to S.E.x.or anyone else if factually neither he nor anyone else is able to make any changes. He is entitled to hear report ahead of time.  
Truly your one sentence response was not constructive.

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Tab 66

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 009997

**From:** Hirsch, Hal <hhirsch@fulbright.com>  
**Sent:** Monday, October 21, 2002 11:06 AM  
**To:** Scrushy, Richard  
**Subject:** FW: Urgent--Privileged Attorney Client and Work Product

---

Tab 67

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
From: Eric Hanson [mailto:erich@usstrategies.com]  
Sent: Monday, October 21, 2002 10:36 AM  
To: Hirsch, Hal  
Subject: RE: Urgent--Privileged Attorney Client and Work Product

Hal, it's my understanding that this has been resolved. Sorry for not getting back to you sooner, I was in a staff meeting. Again, thanks.

Eric.

Eric R. Hanson  
U.S. Strategies Corp.  
319 Clematis Street, Suite 900  
West Palm Beach, FL 33401  
Tel: (561) 804-9414  
Fax: (561) 804-9416

-----Original Message-----

From: Hirsch, Hal [mailto:hhirsch@fulbright.com]  
Sent: Monday, October 21, 2002 8:07 AM  
To: R. Hanson Eric (E-mail)  
Subject: FW: Urgent--Privieged Attorney Client and Work Product

Can you help me on this, please.  
-hnh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----

From: Hirsch, Hal  
Sent: Monday, October 21, 2002 7:25 AM  
To: 'LDavis@PattonBoggs.com'  
Subject: Re: Urgent--Privieged Attorney Client and Work Product

Dispite the issues of propriety, when the SEC demands advise as to who had pre-knowledge of the Report before its release, as it always does, do you really think that it is wise to say that RMS was given the opportunity to 'influence' the Report? This would undermine all F&J has done  
-hnh  
Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP

666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
From: Davis, Lanny <LDavis@PattonBoggs.com>  
To: 'hhirsch@fulbright.com' <hhirsch@fulbright.com>  
Sent: Mon Oct 21 05:21:55 2002  
Subject: Re: Urgent--Privieged Attorney Client and Work Product

I don't understand this message, Hal. You said in your email over weekend we could read penultimate draft. If not, then I need you to read the draft to RS et al. Will you respond to that portion of my email please?

This e-mail message contains confidential, privileged information intended solely for the addressee. Please do not read, copy, or disseminate it unless you are the addressee. If you have received it in error, please call us (collect) at (202) 457-6000 and ask to speak with the message sender. Also, we would appreciate your forwarding the message back to us and deleting it from your system. Thank you.

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Fulbright & Jaworski L.L.P.  
A Registered Limited Liability Partnership  
666 Fifth Avenue, 31st Floor  
New York, New York 10103-3198  
www.fulbright.com

MEMORANDUM

Tab 68

ATTORNEY-CLIENT PRIVILEGED MATERIAL  
ATTORNEY WORK PRODUCT DOCTRINE APPLIES

**TO:** William W. Horton  
**FROM:** Hal M. Hirsch  
Richard W. Beckler  
**DATE:** March 6, 2003  
**RE:** Recollection of Proceedings of October 22, 2002 Board of Directors Meeting of HealthSouth Corporation

---

You have requested that we provide you with a memorandum containing our recollections of the proceedings of the meeting of the Board of Directors of HealthSouth that was held on October 22, 2002 (the "Meeting"). Mr. Hirsch attended the Meeting in person and Mr. Beckler attended the Meeting by conference telephone.

We remind you that we were not requested to take minutes of the Meeting and, therefore, did not undertake to prepare any minutes of the Meeting. Please also note that our recollection of the Meeting's proceedings may not accurately reflect the full content of the matters discussed at the Meeting and may omit some of the discussions held during the course of the Meeting. This memo should not be considered to be the minutes of the Meeting and the recollection of the proceedings provided in this memo is not intended to constitute advice as to the appropriate content of the minutes of the Meeting.

Our recollection is that the board members who attended the Meeting were Jack Chamberlin, Sage Givens, George Strong, Charles Newhall, John Hanson, Robert May, Larry Striplin, Richard Scrushy, and Phillip Watkins. Lanny Davis, of Patton Boggs LLP, also was a guest at the Meeting and was present by conference telephone. We cannot assure you, however, that this is a full and accurate list of the persons who attended the Meeting.

Set forth below is a synopsis of our recollection of the proceedings of the Meeting:

At the beginning of the Meeting, Mr. Scrushy stated that the Fulbright & Jaworski L.L.P. report would take up most of the Meeting.

Mr. Scrushy then reported that a national survey conducted by a corporate governance firm which graded public companies gave HealthSouth a grade of 75%; it

March 6, 2003  
Page 2

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TREATMENT REQUESTED

gave The Walt Disney Company a grade of 5%. According to this survey, HealthSouth's grade put HealthSouth in the top 90% of companies surveyed.

Mr. Scrushy reported that he met with Herb Denton in New York, and that they had a good exchange. He stated to Mr. Denton that HealthSouth is cooperating with the SEC. Mr. Denton would propose individuals to sit on HealthSouth's Board of Directors and/or the corporate governance committee. Mr. Denton told Mr. Scrushy that he wanted to work with HealthSouth, although Mr. Scrushy mentioned to the Board that in the past Mr. Denton had gone hostile with other companies.

Mr. Scrushy informed the Board that he had met with Stephens, an Arkansas investment banking firm.

Mr. Scrushy reported that he had discussions with AIG, and at that point in time, they had only exchanged documents. AIG has a product which would relieve a company of potential litigation liability for a set price. Mr. Scrushy said that senior management of AIG discussed with Mr. Scrushy the possibility of HealthSouth buying out its potential litigation liability and AIG taking the risk of a judgment in the litigation. AIG indicated that they would be willing to review HealthSouth's litigation.

Mr. Hirsch then stated that Fulbright & Jaworski L.L.P. had prepared a report based on the firm's review of certain matters for the time period December 2001 through September 2002. Mr. Hirsch read the report of Fulbright & Jaworski L.L.P. to the Board. Following his reading of the report, in response to an inquiry, Mr. Hirsch stated that, as requested, there are no restrictions on the Board with respect to the use of Fulbright & Jaworski L.L.P.'s report, but he advised that because the report contains attorney-client privileged and attorney work product material, releasing the report or a summary thereof could result in a waiver of such privileges as to the matters contained in the report.

Joel Gordon's letter to Richard Scrushy was also discussed and Mr. Davis read a proposed response to Mr. Gordon. The Board felt that it was best not to respond in writing to Mr. Gordon's letter, though no decision was made.

Thereafter, a discussion ensued concerning additional data the Board sought concerning the Fulbright & Jaworski L.L.P. report. Mr. Scrushy suggested that, until this follow-up is completed, a press release should not be issued relating to the report of Fulbright & Jaworski L.L.P.

Mr. May inquired as to the contents of a possible press release on the matters contained in the Fulbright & Jaworski L.L.P. report. Mr. Davis discussed options for a press release.

Mr. May suggested that the chronology section of the report should not be released at that time because the Company's investigation was on-going and because there was a reference in the report to document destruction by Company personnel. Mr. Scrushy requested that Robert May, John Hanson and Fulbright & Jaworski L.L.P. investigate the document destruction matter further and report back to the Board in the next two weeks on the matter. Mr. Scrushy stated that it is important to understand what

March 6, 2003  
Page 3

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TREATMENT REQUESTED

was destroyed and that he wanted clarification on the issue. He indicated that employees had been told not to destroy any documents. It was also discussed that it was possible that the document destruction was purely routine, because of HealthSouth's obligations under federal law to destroy patient information. Mr. Scrusy stated that he ordered the removal of all shredders from HealthSouth's corporate offices, and that such shredders were removed upon his request.

Mr. Scrusy requested that Fulbright & Jaworski L.L.P. also investigate further as to whether Transmittal 1753 or the group therapy policy addressed therein was discussed at the July 8, 2002 Monday Morning Meeting.

Mr. Hirsch stated that an accounting firm had been engaged to review the financial impact of Transmittal 1753.

The Board agreed, without adopting a resolution, that the Fulbright & Jaworski L.L.P. report would not be released to the press or sent to the SEC at that time, but that this should be done sooner rather than later.

The Board was reminded that the earnings release call was scheduled for November 5, and that every effort should be made to get the answers and report them prior to that date.

The Board then discussed the scheduling of its next meeting and decided it should be held on Tuesday, October 29, 2002.

HMH  
RWB

**PATTON BOGGGS LLP**  
ATTORNEYS AT LAW

February 14, 2003

VIA FEDERAL EXPRESS

Tab 69

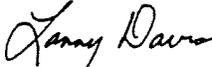
Mr. Richard M. Scrushy  
Chairman of the Board  
HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

Enclosed is a copy of minutes that Adam Goldberg took of the October 22, 2002 executive session of the Board of Directors. I wanted to ensure that you had a copy of the enclosed for two reasons: (1) it reflects the seriousness and appropriateness with which you and the Board of Directors have approached the applicable issues; and (2) in case it is responsive to any document requests in the civil litigation or government inquiries. I am sending it to you rather than Bill Horton because the minutes are of an executive session in which Bill did not participate.

Please call me if you have any questions.

Best regards,



Lanny J. Davis

Enclosure

Doc. 683777

**HHEC 247-1855**  
Confidential Treatment  
Requested by HealthSouth Corp.

**HEALTHSOUTH CORPORATION**  
**Minutes of Executive Session Board Meeting: October 22, 2002**

This Board meeting was held in executive session – no officers of the company attended the meeting. The meeting was held by conference call, with certain Board members present at HealthSouth headquarters in Birmingham. The following Board members attended the meeting and were present at the Birmingham headquarters: Richard Scrusby (Chairman); Robert May; Larry Striplin, Jr.; and Phil Watkins. The following Board members participated in the meeting by telephone: Jon Hanson; C. Sage Givens; Jack Chamberlain; Joel Gordon; and George Strong. C. Sage Givens missed portions of the meeting. Also participating in the meeting were the following outside counsel: Lanny Davis (Patton Boggs); Dick Beckler (Fulbright & Jaworski); Hal Hirsch (Fulbright & Jaworski); and Adam Goldberg (Patton Boggs).

The Chairman called the meeting to order and described certain corporate matters. The Chairman informed the Board about the Chairman's meeting with Bert Denton and described it as positive. The Chairman also informed the Board about his meeting with AIG about the possibility of AIG assuming the liability risk from outstanding litigation for a set fee. The Chairman explained to the Board that he will be continuing discussions with AIG on that matter.

The Chairman then asked Lanny Davis, outside counsel, to provide additional information on the Denton and AIG meetings. Mr. Davis provided additional details on the meeting and on subsequent conversations that Mr. Davis had with Mr. Denton. Mr. Davis also provided additional information on the Chairman's meeting with AIG.

The Chairman then asked Hal Hirsch, outside counsel, to present findings of Fulbright & Jaworski to the Board related to the timing of the Chairman's stock transactions in May and July. Mr. Hirsch described his law firm's inquiry, cautioned the Board about privilege issues related to dissemination of Fulbright's findings, and read a Fulbright & Jaworski report to the Board. A copy of the report read to the Board is attached to these minutes.

Following Mr. Hirsch's reading of the report, the Chairman then asked the Board if it had questions for outside counsel. Mr. Strong asked a question about a potential news release and Mr. Davis responded. The Chairman then asked Mr. Hirsch why no one got a copy of the report prior to the meeting and Mr. Hirsch explained that he wanted to avoid any appearance that his law firm's findings were influenced.

The Chairman then proposed that Robert May and Jon Hanson review the report and back-up materials collected by Fulbright & Jaworski, take comments from Board members, and report to the Board at a meeting to be held on October 29, 2002 on matters such as whether disciplinary action should be taken.

The Chairman also stated that the document destruction issues raised in the report must be pursued quickly. Mr. Hirsch explained that it is important for the Board to note that the company destroys certain documents in the normal course and practice to prevent competitors from getting information. Mr. Hirsch cautioned the Board that no one should jump to rash

conclusions. The Board then discussed related issues and Mr. Hirsch stated that Fulbright & Jaworski would supplement the report with respect to the document destruction issue. Mr. Hirsch reported to the Board that on the day that Mr. Hirsch informed the Chairman about document destruction, the Chairman ordered that the company's security office disconnect all shredders and lock them up in a room monitored by security.

Mr. Stripland then asked certain questions regarding the company's estimates of the financial impact of the May 2002 CMS rule change and the Chairman responded. The Chairman explained that FTI and Fulbright & Jaworski were examining the accuracy of the company's \$175 million EBITDA estimate and that the Board should receive a report on such matters in the next week or two.

Robert May then informed the Board about certain matters relating to the Corporate Governance Committee chaired by Mr. May. Mr. May explained that he was working out matters with Barbara Franklin, Jack Kemp, and Connie Mack regarding their potential service as advisers to the Corporate Governance Committee. Mr. May also explained that the Committee was holding discussions with search firms to identify potential independent Board members.

Mr. May then asked Hal Hirsch a series of questions regarding Fulbright and Jaworski's findings as to when the Chairman, the Board, and members of the Compensation Committee were informed about certain matters. Mr. Hirsch responded.

The Chairman then ended the meeting.

**Hirsch, Hal**

**From:** Dowdell, Tom  
**Sent:** Wednesday, October 23, 2002 5:39 PM  
**To:** Beckler, Richard; Walker, Joseph; Galant, Felice  
**Cc:** Hirsch, Hal  
**Subject:** HS

**Tab 70**

Dick, Joe and Felice:

I first interviewed Susan Jones-Smith (SJS) on Friday, September 27. We did not become aware of the Monday Morning Meetings (MMM), in general, until the following Monday afternoon, September 30, during our interview with Jean Davis (JD), which I recall began at 4 PM CT. Thus, my notes from the September 27 interview (also attended by Martin Cohen of FTI, who is in Birmingham today if you want to see his notes) do not discuss the MMM at all.

JD recalled in her September 30 interview that she mentioned Transmittal 1753 at a MMM in late July or early August. We have confirmed that the first MMM following the July 8 meeting was on or about August 20.

I spoke with Mat Kirtland, who was present during my interview of Rick Schmitt, the first interview on Tuesday, October 1. Mat's notes indicate that in response to my question whether he recalls if Transmittal 1753 was discussed by anyone at a Monday Morning Meeting, Mr. Schmitt replied, "Honestly, I do not remember." He did confirm that he personally attended the 7/8 MMM. Mat is getting his notes typed.

I next spoke on October 1 spoke with SJS and JD who had traveled to Washington, D.C. JD indicated in this telephone conference that she recalls very briefly describing during an August or early September 2002 MMM the overall issues surrounding group therapy, but did not recall specifically mentioned Transmittal 1753 or the policy therein. SJS then described that she may have given a brief report regarding Transmittal 1753 or the policy therein, and her interaction with Dr. McKinney at Blue Cross Blue Shield Alabama, regarding application of the transmittal in the July 8 or August 20, 2002 MMM.

Irv Cohen and I on October 1 next spoke with Patrick A. Foster (PAT). He first recalled that JD recalled informing the assembled that CMS was not giving the company clarification regarding Transmittal 1753 at a MMM, perhaps the September 9, 2002 meeting. PAT recalled SJS brought up her discussion with Dr. McKinney at a MMM before the meeting at which JD made her remark regarding CMS is not giving us clarification.

Bill Horton's (BH) Activity Report for 6/17/02 provides in part: "Follow up with Operations and Reimbursement on new Medicare Carriers Manual language re: group therapy."

BH's Activity Report for 7/8/02 provides in part: "Continue working on group therapy issues."

BH does not recall Transmittal 1753 being specifically mentioned at a MMM and said that is not a concept that would likely be discussed at such a meeting.

At our interview of SJS last Thursday, October 17, she reviewed her Activity Report for the 7/8/02 MMM, and stated that she almost always reads her Activity Report for the meeting word for word because she wants to sit down as quickly as possible, she specifically recalled reading to the assembled "Transmittal 1753" at such meeting, and while RS commented on her presentation item regarding positive cash collections, there were no questions or any follow-up discussion relating to her "Transmittal 1753" discussion point.

The bottom line:

1. RS was present at the 7/8/ MMM.
2. RS had access on a laptop computer to SJS's Activity Report for such meeting, which states in relevant part, "Working with BCBS AL on interpretation of various medicare regulations (transmittal 1753) pertaining to Group Therapy). Steve Speil is arranging a meeting with CMS for us to discuss the various interpretations."
3. SJS unequivocally recounted to Joe Walker and me on October 17 that she specifically recalls reading "Transmittal 1753" at the 7/8/02 MMS.
4. Other interviewees' memories are not clear.

CONFIDENTIAL TREATMENT REQUESTED  
 By Dechert LLP on behalf of its client

FJ 010758

729

Tom Dowdell  
Fulbright & Jaworski L.L.P.  
tdowdell@fulbright.com  
202-662-4503/phone  
202-662-4643/fax  
\*\*\*\*\*

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\*\*\*\*\*

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 010759

**Goldberg, Adam**

**From:** Sjoquist, Mary  
**Sent:** Thursday, October 24, 2002 7:07 PM  
**To:** Davis, Lanny; Goldberg, Adam  
**Subject:** Compliance Integrity Agreement

Tab 71

It certainly appears that Healthsouth is not in compliance with the letter of the Compliance Integrity Agreement ("CIA"). The Agreement, which was entered into on May 17, 2001, requires the Company to have a Compliance Committee consisting of three independent directors and one member of senior management. The current members of the Committee are Joel Gordon, Chairman, Phil Watkins and Chuck Newhall who are the directors and Brad Hale who is the management representative. Joel Gordon does not appear to be an independent director. Brad Hale refers to him as a consultant and advisor who is on the payroll of Healthsouth. In 2001, he had W-2 wages in the amount of \$250,950.11 and is still employed. Since this was the constitution of the Committee at the time that the CIA was entered into, I am not sure how Healthsouth justified retaining Joel Gordon on the Committee after the entry and wonder if perhaps they got a waiver from the OIG. I need to see Board resolutions establishing the Committee and any changes to Committee membership since the Committee was established about 5 or 6 years ago. Is Bill Horton my source for this?

In the event that Healthsouth did not get a waiver of the provision, Healthsouth could arguably be subject to a \$2,500 per day penalty for not fully and timely complying with all of its obligations under the CIA, namely, failing to have a Compliance Committee in place meeting the requirements of the CIA. This penalty would accrue from the day after the day on which Healthsouth initially failed to meet the Committee obligation, or since May 18, 2001, presumably. Alternatively, in the event that the \$2,500 penalty is not applicable, the OIG could impose a penalty of \$1,000 per day. The penalty would begin to accumulate 10 days after notification by the OIG of failure to comply if the failure has not been cured.

Under the various notice provisions, it could also be argued that Healthsouth failed to notify the OIG within 15 days that it had taken an action that would affect the Committee's ability to perform the duties necessary to meet the obligations in the CIA, that action being placing a non-independent director on the Committee.

I don't think that this failure to comply would be deemed to be a Material Deficiency under the Agreement that constitutes a "matter that a reasonable person would consider a potential violation of criminal, civil or administrative laws applicable to any Federal health care program for which penalties or exclusion may be authorized", but have not researched this issue. In the event that having a non independent director on the Committee would be deemed to be a Material Deficiency, then a further notification would have been required by the CIA.

Under the CIA, Healthsouth was to employ Independent Review Organizations to do several different audits one of which was a compliance review of the CIA. One portion of this review was to determine whether or not Healthsouth had a properly constituted Compliance Committee. This report was to have been completed for the first year of the CIA's term. I need to request this review.

In conclusion, assuming that Healthsouth did not obtain a waiver for Mr. Gordon, it would seem that the Company should cut its potential losses by having Mr. Gordon resign from his position and appointing a replacement to the Committee who is a truly independent director. We should also assure that the other two directors are truly independent. Before determining whether or when to contact DOJ, we need to talk to the Company to determine how this happened.

Call me when you get a minute.

**Melendez, Madelene**

**From:** Davis, Lanny Tab 72  
**Sent:** Thursday, October 24, 2002 9:39 PM  
**To:** O'Connor, Eileen  
**Subject:** Fw: Attorney/Client Privilege Draft Release for Comments--URGENT

Please re-write and fill in inserts. Do you have report? Should be on my email from Hal Tuesday.. day of Board meeting.

-----Original Message-----

From: Hervey, Jason <Jason.Hervey@healthsouth.com>  
 To: Scrushy, Richard <rscrushy@healthsouth.com>; 'ldavis@pattonboggs.com' <LDavis@PattonBoggs.com>  
 Sent: Thu Oct 24 19:06:58 2002  
 Subject: Attorney/Client Privilege Draft Release for Comments

HealthSouth announced today that Houston based law firm Fulbright & Jaworski has completed their investigation of Richard Scrushy concerning transmittal 1753, and the option exercise and sale and the loan repayment by Mr. Scrushy. The Fulbright & Jaworski report stated they reviewed (Lanny-insert all relevant review statistics and tactics from the FB) report) Fulbright & Jaworski has concluded the following (Lanny insert final conclusion here). Subsequently, the Board of Directors has voted to reinstate Mr. Scrushy as Chief Executive Officer. "I am so excited to once again be CEO, and i thank the board for their continued trust in my ability to lead our great company and create value for the shareholders, and this is why i have decided to work for free until we restore the vitality of our stock and its reflected in its price" said Mr. Scrushy healthsouth chairman of the board and ceo. Mr. William T. Owens has resumed his post as Chief Operating Officer and has stepped off the Board of Directors based on the boards decision to suspend the surgery center seperation transaction. The Board beleives Mr. Scrushy is the most appropriate person to serve as CEO based on his experience and knowledge of the business and his extensive relationships with Healthsouths vast amount of referring physicians.

The Board has also approved other items of governance;

- \*agreed to add 4 new independent directors- 3 this year and 1 next year
- \* elected governance committee members- Jack Kemp, Barbra Franklin, & Connie Mack (confirm)
- \* (List other selected corporate governance changes)

Mr. Scrushy had previously offered Mr. Herbert Denton a slot on the governance committee as an advisor. Mr. Denton has accepted and Mr. Scrushy has granted Mr. Denton an additional slot. The committee will be dedicated to the following (list mission of committee) " Mr. Denton has some good recommendations that we will believe will improve our governance and we will be working together to achieve that goal," Mr. Scrushy said. "The company has also hired institutional shareholder services (ISS) to consult with management and the Board of Directors on governance issues as well as the implementation of their web based product "CGQ" which will (Brad Hale to fill in paragraph)," said Mr. Scrushy.

HealthSouth has hired Little Rock, Arkansas based investment banking firm Stephens Inc. to assist and advise on strategic and governance issues as well. The company has also pacted with the director search group to assist the company in finding new qualified independent directors.

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**Hirsch, Hal**

**From:** Kaplan, Carl  
**Sent:** Friday, October 25, 2002 1:55 PM  
**To:** Hirsch, Hal  
**Subject:** RE: Lanny Davis

Tab 73

davis showed up with goldberg and schrieber(litigator)(?) we chatted for about 10 minutes and then i let them use my car to drop me off and go to airport other than general chitchat, etc davis expressed some concern as to exactly what use we were in the process and said that the client(no name or indiv given) felt the same way ????? maybe he was referring to our approach to sec submission couldn't tell i will leave for depke's thing soon but will have my blackberry cfor next 1/2 hour: 2125853553

-----Original Message-----  
**From:** Hirsch, Hal  
**To:** Kaplan, Carl  
**Sent:** 10/24/02 7:05 PM  
**Subject:** Lanny Davis

'Evening:  
 Lanny is my bestest friend again. Now that Helen is well, I will spend tomorrow with her and work from home. I have spent the last hour and a half talking with Lanny - to much to write - but I have credited you with all but the birth of Christ. Lanny wants to meet you. He will be in the City tomorrow and may have time for either lunch or to stop by. He will call you in the morning. Call me when you get in so we can come to speed if you like. Life is a funny thing...

-hnh  
 M. Hirsch, Partner  
 Bright & Jaworski, LLP  
 600 Fifth Avenue  
 New York, New York 10103  
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 (201) 788-9800 (cell)  
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 hhirsch@fulbright.com

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**CONFIDENTIAL TREATMENT REQUESTED**  
**By Dechert LLP on behalf of its client**

FJ 010056

**From:** Hervey, Jason  
**Sent:** Saturday, October 26, 2002 1:11 PM Tab 74  
**To:** Scrushy, Richard, ldavis@pattonboggs.com  
**Subject:** Fw: WORK PRODUCT PRIVLIGED AND CONFIDENTIAL

---

Just got off the with Dick who is in his office working away. He wanted to add all of jim goodraus law credentials (give a lot of credibility to document shredding piece) so I spoke to jim and told dick. He says we will be pleased (that's what they said last time) but I told him we need ASAP. They are "working away".  
Let us know lanny what hal says.  
Jason

-----Original Message-----

**From:** Hervey, Jason <Jason.Hervey@healthsouth.com>  
**To:** 'ldavis@pattonboggs.com' <ldavis@pattonboggs.com>  
**CC:** Scrushy, Richard <rscrushy@healthsouth.com>  
**Sent:** Sat Oct 26 11:23:48 2002  
**Subject:** WORK PRODUCT PRIVLIGED AND CONFIDENTIAL

I know from speaking to Dick Beckler several times yesterday that today "should" be the day that they were to come into the home stretch on the report. If you lanny start to put the pressure on Hal, I will on Dick today to have the final done by tommorrow. You know that there will still be a final language haggle and if it were up to them they would give it to us tuesday morning. I will let you know when I connect with dick and report back where he is at. He told me he would be in the office with Joe working on it.  
Thanks  
Jh

734

**Melendez, Madelene**

---

**From:** Davis, Lanny  
**Sent:** Saturday, October 26, 2002 6:03 PM  
**To:** 'rscrushy@healthsouth.com'; 'jason.hervey@healthsouth.com'; 'ehanson@usstrategies.com'  
**Subject:** Attorney Client Privileged

Hope you are all having a good and relaxing weekend. All progressing well on my end--talk to Hal. Should hear reading tomorrow. Denton and I talked four times today. Almost there. A few issues remaining.

I know press release needs changing. Won't have Corp Governance committee in time by Tuesday. Won't have 175M issue either. That's ok. Will have positive follow-ups. Also need to talk re Stevens after talk with Denton.

Richard--if you would like to talk to me tomorrow, please page me a/c. 1888-997-3706.

Best to all,

Lanny

Tab 75

**Hirsch, Hal**

**From:** Hirsch, Hal  
**Sent:** Tuesday, October 29, 2002 10:33 AM  
**To:** 'Horton, Bill'  
**Subject:** RE: PRIVILEGED AND CONFIDENTIAL

Bill:

Thank you for send us a copy of the proposed press release which we have not seen nor been apprised of prior hereto. This press release goes beyond what F&J set forth in the Reports that we presented to the Board. It would be very unfortunate if the Company reported publicly information that was inconsistent, hence creating a friction and problem for the Company.

-hnh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
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 New York, New York 10103  
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 hhirsch@fulbright.com

Tab 76

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-----Original Message-----

**From:** Horton, Bill [mailto:Bill.Horton@healthsouth.com]  
**Sent:** Tuesday, October 29, 2002 10:23 AM  
**To:** Hal M. Hirsch (E-mail)  
**Subject:** PRIVILEGED AND CONFIDENTIAL  
**Importance:** High

Set forth below is the text of a draft press release apparently prepared by Lanny. I have various comments and changes, but in particular I would like to know (a) is the quote attributed to your report accurate, (b) if we quote from your report directly (as opposed to paraphrasing or summarizing), is it your position that we then have to provide the report immediately to the SEC, and (c) do you guys like to be identified as being from Houston?

For Release: Tuesday, October 29, 2002  
 For further information, contact:

HealthSouth Chairman Richard Scrushy Cleared by Outside Investigation  
 Of Advance Knowledge of Medicare Rule Change Prior to Stock Transactions

Richard Scrushy, Chairman of HealthSouth Corporation was cleared by an outside investigation conducted by a national law firm of all allegations of inside knowledge concerning the impact of a Medicare reimbursement rule change prior to stock and loan repayment transactions in May and July 2002.

CONFIDENTIAL TREATMENT REQUESTED  
 By Dechert LLP on behalf of its client

FJ 010818

Fulbright & Jaworski, a national law firm based in Houston, Texas, concluded that Mr. Scrushy had no inkling or knowledge of any Medicare reimbursement rule change or its financial impact on the Company until two months after he sold stock on May 14 due to expiring stock options and a week after he had repaid a stock loan on July 31.

Fulbright reached its findings after concluding an extensive six-week investigation that began on September 17. Fulbright's outside review involved interviews with dozens of key HealthSouth employees and senior managers, members of the Board of Directors, and others outside the Company and included the review of internal Company email, documents, spread sheets, and other types of electronic data from approximately 39,000 documents totaling 546,300 pages.

The Fulbright Report concluded:

"Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrushy was aware at the time of his option exercise and sale of HealthSouth common stock on May 14, 2002, of the pending issuance of Transmittal 1753 [the Medicare rule change]. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrushy knew prior to the time of the transfer by Mr. Scrushy of HealthSouth common stock to HealthSouth on or about July 31, 2002, in satisfaction of the principal amount of a loan made to him by HealthSouth under its 1999 Executive Equity Loan Plan, of: (i) Transmittal 1753 [the Medicare reimbursement rule change]; (ii) the application of Transmittal 1753 [the reimbursement rule change] to the Company's various outpatient therapy services; or (iii) the Transmittal's potential financial effect on the

Company."

The Company says that it will continue to cooperate fully in all respects with the SEC in their investigation of these matters, of which the Company was first aware on September 18. The Company had notified the SEC on September 15 that it would fully cooperate and turn over all internal investigations in the event the SEC conducted an inquiry concerning Mr. Scrushy's stock transactions.

"This thorough and independent review conducted by Fulbright and Jaworski puts to rest any question whether Mr. Scrushy had any inkling or knowledge of the Medicare reimbursement rule change prior to his stock transactions in May and July 2002," said independent director Mr. Robert May, chairman of the Board's Special Corporate Governance Committee and Special Litigation Committee. "This report confirms what Mr. Scrushy has been stating from the outset."

"I am pleased by Fulbright's confirmation of the facts and the truth concerning my absence of any knowledge of the Medicare reimbursement rule change prior to my stock transactions," Mr. Scrushy said.

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**Hirsch, Hal**

**From:** Hirsch, Hal  
**Sent:** Tuesday, October 29, 2002 1:03 PM  
**To:** Gold, Neil  
**Subject:** Re: PRIVILEGED AND CONFIDENTIAL

Carl and I told Horton much of what you stated though we all acknowledge a lack of control. Horton is working on improving the statement. Be good.

-nmh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
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 hhirsch@fulbright.com

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-----Original Message-----

**From:** Gold, Neil <ngold@fulbright.com>  
**To:** Hirsch, Hal <hhirsch@fulbright.com>  
**CC:** Galant, Felice <fgalant@fulbright.com>; deButts, Robert <rdebutts@fulbright.com>  
**Sent:** Tue Oct 29 11:52:58 2002  
**Subject:** RE: PRIVILEGED AND CONFIDENTIAL

Hal-This is hilarious. Is it a parody or is it for real? A few thoughts and questions:

1. I did not know we had the power to "clear" Richard. In fact our letter says quite the contrary.
2. What is the legal definition of "inkling"? Is it more than a scintilla?
3. Do these idiots realize that two months after May 14 is July 14?
4. Our investigation began on September 24, not September 17, and was essentially completed (except for the supplemental reports) by October 21, a period of four, not six, weeks.
5. We did not review 59,000 documents and 546,300 pages. We merely applied our search parameters to those documents and pages. Our report specifically states that we did not examine documents not responsive to the search terms.
6. Our "conclusion" is not stated accurately as it omits the "In view of..." clause that begins the conclusion in today's letter. To be accurate, the release would have to state ".....Fulbright & Jaworski L.L.P. has uncovered".
7. There is no way to confirm a person's "absence of knowledge".

These are just top of the head thoughts about this. Have a good flight.

-----Original Message-----

**From:** Hirsch, Hal  
**Sent:** Tuesday, October 29, 2002 12:08 PM  
**To:** Gold, Neil; Galant, Felice  
**Subject:** FW: PRIVILEGED AND CONFIDENTIAL

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)

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 By Dechert LLP on behalf of its client

FJ 010829

(212 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----  
From: Hirsch, Hal  
Sent: Tuesday, October 29, 2002 11:39 AM  
To: 'Horton, Bill'; Kaplan, Carl  
Subject: RE: PRIVILEGED AND CONFIDENTIAL

My reply was contained in our oral discussions this morning with Carl. Thank you for seeking our thoughts in this matter and appreciating our concerns.  
-hnh

Hal M. Hirsch, Partner  
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-----Original Message-----  
From: Horton, Bill [mailto:Bill.Horton@healthsouth.com]  
Sent: Tuesday, October 29, 2002 10:38 AM  
To: 'Hirsch, Hal'  
Subject: RE: PRIVILEGED AND CONFIDENTIAL

Please advise ASAP of corrections/suggestions/clarifications. Thanks.

-----Original Message-----  
From: Hirsch, Hal [mailto:hhirsch@fulbright.com]  
Sent: Tuesday, October 29, 2002 9:33 AM  
To: Horton, Bill  
Subject: RE: PRIVILEGED AND CONFIDENTIAL

Bill:  
Thank you for send us a copy of the proposed press release which we have not seen nor been apprised of prior hereto. This press release goes beyond what F&J set forth in the Reports that we presented to the Board. It would be very unfortunate if the Company reported publicly information that was inconsistent, hence creating a friction and problem for the Company.  
-hnh

Hal M. Hirsch, Partner  
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By Dechert LLP on behalf of its client

**FJ 010830**

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-----Original Message-----  
From: Horton, Bill [mailto:Bill.Horton@healthsouth.com]  
Sent: Tuesday, October 29, 2002 10:23 AM  
To: Hal M. Hirsch (E-mail)  
Subject: PRIVILEGED AND CONFIDENTIAL  
Importance: High

Set forth below is the text of a draft press release apparently prepared by Lanny. I have various comments and changes, but in particular: I would like to know (a) is the quote attributed to your report accurate, (b) if we quote from your report directly (as opposed to paraphrasing or summarizing), is it your position that we then have to provide the report immediately to the SEC, and (c) do you guys like to be identified as being from Houston?

---

For Release: Tuesday, October 29, 2002  
For further information, contact:

HealthSouth Chairman Richard Scrusby Cleared by Outside Investigation  
Of Advance Knowledge of Medicare Rule Change Prior to Stock Transactions  
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Richard Scrusby, Chairman of HealthSouth Corporation was cleared by an outside investigation conducted by a national law firm of all allegations of inside knowledge concerning the impact of a Medicare reimbursement rule change prior to stock and loan repayment transactions in May and July 2002.

Fulbright & Jaworski, a national law firm based in Houston, Texas, concluded that Mr. Scrusby had no inkling or knowledge of any Medicare reimbursement rule change or its financial impact on the Company until two months after he sold stock on May 14 due to expiring stock options and a week after he had repaid a stock loan on July 31.

Fulbright reached its findings after concluding an extensive six-week investigation that began on September 17. Fulbright's outside review involved interviews with dozens of key HealthSouth employees and senior managers, members of the Board of Directors, and others outside the Company and included the review of internal Company email, documents, spread sheets, and other types of electronic data from approximately 59,000 documents totaling 546,300 pages.

The Fulbright Report concluded:

"Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby was aware at the time of the his option exercise and sale of HealthSouth common stock on May 14, 2002, of the pending issuance of Transmittal 1753 [the Medicare rule change]. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby knew prior to the time of the transfer by Mr. Scrusby of HealthSouth common stock to HealthSouth on or about July 31, 2002, in satisfaction of the principal amount of a loan made to him by HealthSouth under its 1999 Executive Equity Loan Plan, of: (i) Transmittal 1753 [the Medicare reimbursement rule change]; (ii) the application of Transmittal 1753 [the reimbursement rule change] to the Company's various outpatient therapy services; or (iii) the Transmittal's potential financial effect on the Company."

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 010831

The Company says that it will continue to cooperate fully in all respects with the SEC in their investigation of these matters, of which the Company was first aware on September 18. The Company had notified the SEC on September 15 that it would fully cooperate and turn over all internal investigations in the event the SEC conducted an inquiry concerning Mr. Scrushy's stock transactions.

"This thorough and independent review conducted by Fulbright and Jaworski puts to rest any question whether Mr. Scrushy had any inkling or knowledge of the Medicare reimbursement rule change prior to his stock transactions in May and July 2002," said independent director Mr. Robert May, chairman of the Board's Special Corporate Governance Committee and Special Litigation Committee. "This report confirms what Mr. Scrushy has been stating from the outset."

"I am pleased by Fulbright's confirmation of the facts and the truth concerning my absence of any knowledge of the Medicare reimbursement rule change prior to my stock transactions," Mr. Scrushy said.

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Hirsch, Hal

---

**From:** Hirsch, Hal  
**Sent:** Tuesday, October 29, 2002 6:33 PM  
**To:** deButts, Robert  
**Cc:** Gold, Neil; Kaplan, Carl; Galant, Felice  
**Subject:** Re: Supplemental Letter

Please check with Carl, I do not recall saying SEC inquiry. Draft an acceptable letter and we will discuss it in the morning. Thank you.

-hnh

Hal M. Hirsch, Partner  
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**From:** deButts, Robert <rdebutts@fulbright.com>  
**To:** Hirsch, Hal <hhirsch@fulbright.com>  
**CC:** Gold, Neil <ngold@fulbright.com>; Kaplan, Carl <ckaplan@fulbright.com>; Galant, Felice <fgalant@fulbright.com>  
**Sent:** Tue Oct 29 17:26:58 2002  
**Subject:** Supplemental Letter

Hal:

In your discussions with Lanny, you should know that Neil feels fairly strongly that in light of our discovery of shreds with "mittal 1753" and the like we cannot deliver the sentence Lanny wants that we uncovered "no evidence that HS personnel destroyed documents relevant to the SEC inquiry." He points out that we deleted a similar sentence from our first letter over the weekend.

Rob

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 010838

HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
OCTOBER 29, 2002  
MINUTES

Tab 79

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 29, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrushy, Chairman of the Board of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Larry D. Striplin, Jr., Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, and Lanny J. Davis of Patton Boggs, LLP. With the exception of Mr. Strong, who participated via a telephonic connection whereby everyone could freely hear and speak to one another, all Directors and guests were physically present with Mr. Scrushy in the Board Room.

Richard M. Scrushy acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrushy at 8:00 a.m. C.S.T.

**Executive Session**

The Meeting began in executive session with Messrs. May and Hanson presenting to the Board all documents provided by the law firm of Fulbright & Jaworski, L.L.P. in connection with its investigation of management's knowledge of CMS Transmittal 1753.

The Board reviewed Fulbright & Jaworski's supplemental letter clearing Mr. Scrushy of all allegations of insider knowledge concerning the impact of a Medicare reimbursement rule change

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LS 0000552

prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 30, 2002.

The Board also agreed to hold a Board Meeting on November 13, 2002, to review final recommendations from Messrs. May and Hanson, if any, regarding members of management's knowledge and understanding of CMS rule changes.

In association with these matters, the Board requested a review to be conducted by a qualified outside party (law professor, retired SEC attorney, etc.) of the Corporation's Legal Services Department, its systems and qualifications of staff, including its Corporate Counsel. Upon conclusion of the review, a summary of findings and recommendations are to be made to the Chairman and the Board of Directors. The Board also directed that the Corporate Counsel should report directly to the Chairman of the Board.

**Compensation Committee Action**

Mr. Scrusby advised the Board that the approval of the Compensation Committee's recommendation of bonuses to be awarded to the Corporation's executive officers had been omitted from the May 16, 2002 Minutes. Mr. Scrusby asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 Minutes amended to reflect this action.

After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. Striplin, the following resolution was unanimously adopted:

RESOLVED, that the Board of Directors hereby ratifies and confirms, as of May 16, 2002, the bonus recommendations made by the Compensation Committee at the May 16, 2002 Board Meeting and the payment of such bonuses in accordance with such recommendations, and further directs that the minutes of the May 16, 2002 Meeting of the Board of Directors be amended to reflect such approval.

In other Compensation Committee business, Mr. May resigned from the Committee and Mr. Chamberlin was asked to serve as Chairman. After discussion, upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the Board of Directors hereby accepts the resignation of Robert P. May from the Compensation Committee and thanks him for his service thereon.

RESOLVED, that John S. Chamberlin is hereby appointed as Chairman of the Compensation Committee, to serve until the next Annual Meeting of the Board of Directors and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal.

**Compliance Committee Action**

The Board discussed Mr. Gordon's ineligibility to serve on the Compliance Committee because of his status as an employed consultant of the Corporation. As a result, Mr. Gordon resigned from the Committee, and Mr. Scrusby requested that Ms. Givens serve on the Committee in place of Mr. Gordon, and that Dr. Watkins serve as its Chairman. After discussion, upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the Board of Directors hereby accepts Joel C. Gordon's resignation from the Compliance Committee and thanks him for his service thereon.

RESOLVED, that C. Sage Givens is hereby appointed to the Compliance Committee, to serve until the next Annual Meeting of the Board of Directors of this Corporation and until her successor is duly appointed and qualified, or until her earlier death, resignation or removal.

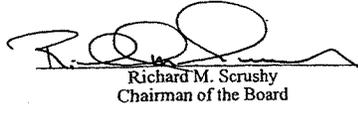
RESOLVED, that Phillip C. Watkins, M.D. is hereby appointed as Chairman of the Compliance Committee, to serve until the next Annual Meeting of the Board of Directors and until his successor is duly appointed and qualified, or until his earlier death, resignation or removal.

**Other Business**

Mr. May distributed to the Board members drafts of charters for the Corporate Governance Committee, Audit Committee, and Compensation Committee, and a draft of an Insider Trading Policy. Mr. May requested that the Board members review each document and return comments to him prior to the next Board Meeting.

There being no further business to transact, the Meeting was adjourned.

  
\_\_\_\_\_  
Brandon O. Hale  
Executive Vice President – Administration  
and Secretary

  
\_\_\_\_\_  
Richard M. Scrusby  
Chairman of the Board

HS-71957.1

CONFIDENTIAL  
TREATMENT REQUESTED

LS 000555

Tab 80

BOD

10/24/02

10/21/02

RMS, LOS, JC, AM  
PCW, JCG, GSB, JH  
(FS)

~~Resistor  
Resistor~~

Corporate Committee → Re-write process  
approvals  
① writing  
② steps  
Discussion  
\* unanimous approval

Compliance Committee

Frank assigned to take  
for Joel

CIA - Joel Gordon not eligible because he  
is not independent.

Joel resign as member of Compliance Committee

- Batt out as <sup>Corp</sup> Compliance Officer  
Guy Smith named as Corp Compliance Officer

Corp Governance

\* ① Who is President as Corporate Governance Committee?

Sub May

Sub May  
Distributions

Discussion of <sup>Draft</sup> Insider Trading Policy

Draft Charter of Corporate Governance Committee

Draft Charter for Compensation Committee

Modified Audit Committee Charter

Jan Hansen

||

per Sub May call

My hand out Drafts of  
Charter for Governance Committee,  
Audit Committee, Compensation Committee  
& Insider Trading Policy and request  
Board members to review & return  
comments to Mr. May prior to the  
next Board meeting

Add to Minutes

① Sage <sup>Graves</sup> replace Joel on Caplan

Phil Wittens will chair

Attached minutes

Compendium Committee

Chairman - Chair

May - ~~OT~~ Corp

Wittens
Chubb - chair
Stimp

At

Chairman asked to review legal Dept  
- by outside legal firm (retired, admin-  
train) to review functions, systems  
qualifications of all to include Gen  
Counsel & make recommendations to  
Chairman & Board

① Board voted you could address  
immediately report to Chairman of Congress

Board spent ~~4 hours~~ reviewing the  
Mays & Hanger report to Board all documents  
provided by F+J on their jurisdiction  
concerning the revision the Board asked  
them to perform

Board received F+J Supplemental letter  
regarding the chairman of RM &  
voted to release to press 10/30 the  
results of that letter

Board also agreed to bill another  
units Nov 13 to receive final  
recommendation from Mays & Hanger if any,  
regarding other or Margaret's signature  
to their undershelf & Keady with  
regard to CMS rule changes

Draft

HealthSouth Corporation  
 Meeting of the Board of Directors  
 October 29, 2002  
 Minutes

A Meeting of the Board of Directors of HealthSouth Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated October 29, 2002, a copy of which is attached to these Minutes.

Board Member Present: RMS, LDS, JSC, RPM,  
 PCW, JCG, CSG, JFH  
 via telephone: GHS

Guest Present: Larry Davis

Richard M. Scorsby acted as Chairman of the Meeting and Brandon O'Hole acted as Secretary.

The Meeting was called to order by Mr. Scorsby at 8:00 AM CST.

### Executive Session

The Meeting began in Executive Session with Messrs May and Hanson presenting to the Board all documents provided by Fulbright and Jaworski as a result of the investigation and review. The Board requested them to conduct - regarding Messrs. Fulbright and Jaworski's knowledge of CMS Transmittal 1753.

The Board reviewed Fulbright and Jaworski's Supplemental letter regarding the clearing Mr. Sandy of all allegations of insider knowledge concerning the impact of Medicare reimbursement rule change prior to his stock and loan repayment transactions in May and July 2002. The Board voted to release to the press the results of the findings on October 30, 2002.

HHEC 293-0259  
Confidential Treatment  
Requested by HealthSouth Corp.

The Board also agreed to hold another a Board of Director meeting on November 13, 2002 to review Final recommendations from Messrs May and Hanson, if any, regarding others in Management relative to their understanding and knowledge with regard to CMS rule changes.

In association with these matters the Board requesting a review to be conducted

by a qualified outside party (law professor, retired SEC attorney, etc) of the Corporation's legal Department. The review is to include an evaluation of the entire legal Department, its systems and qualifications of staff <sup>including</sup> the Council Council. Upon conclusion of the review recommendations are to be made to the Chairman and the Board of Directors.

In other Compensation Committee Minutes, Mr. May suggested that the Committee and Mr. Chubb had asked to serve as Chairman

Compensation Committee Action

on May 16, 2002  
 Mr. Scrosby advised the Board that ~~the~~ the Board's approval of the Compensation Committee's recommendation on April 29, 2002 is because to be amended to the Corporation's Executive Officers had been omitted from the May 16, 2002 minutes. Mr. Scrosby asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 minutes amended to reflect this action. A motion was made by Dr. Withers and seconded by Mr. Stoyben and unanimously approved by the Board.

Compliance Committee Action

The Board discussed the fact that Mr. Gordon

HHEC 293-0260  
 Confidential Treatment  
 Requested by HealthSouth Corp.

was not eligible to serve on the Compliance Committee because he does not meet the test as an independent Director. As a result Mr. Gordon resigned from the Committee and Mr. Scorsby requested Ms. Green serve on the Committee in place of Mr. Gordon and Dr. Watkins serve as Chairman.

#### Other business

Mr. May distributed to Board members drafts of charters for the Corporate Governance Committee, Audit Committee, Compliance Committee and a draft of an Insider Trading Policy. Mr. May requests Board members to review each and return comments to him prior to the next Board meeting.

Draft

HealthSouth Corporation  
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 PCW, JCB, CSK, JEH  
 Waiver: GHS

Guest Present: Larry Davis

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to summary review

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In other Corporation Committee, Mr. My missed the Committee and the Chairman was asked to serve as Chairman

Corporation Committee Action

on May 11, 2002

Mr. Secord advised the Board that ~~the~~ the Board's approval of the Corporation Committee's recommendation on April 29, 2002 is because to be amended to the Corporation's Executive Officers had been omitted from the May 16, 2002 minutes. Mr. Secord asked the Board to ratify the Committee's recommendations and to have the May 16, 2002 minutes amended to reflect this action. A motion was made by Mr. Wetters and seconded by Mr. Stripling and unanimously approved by the Board.

Compliance Committee Action

The Board discussed the fact that Mr. Gordon

was not eligible to serve on the Compliance Committee because he does not meet the test as an independent Director. As a result Mr. Gordon resigned from the Committee and Mr. Scandly requested Ms. Gross serve on the Committee in place of Mr. Gordon and Dr. Watkins serve as Chairman.

Other business

Mr. May distributed to Board members drafts of charters for the Corporate Governance Committee, Audit Committee, Compensation Committee and a draft of an Insider Trading Policy. Mr. May requested Board members to review each and return comments to him prior to the next Board meeting.

HealthSouth: healthcare in surgery, anesthesia, diagnostic medicine



RESOURCE CENTER :: HEALTHY LIVING :: SPORTS HEALTH :: OUR SERVICES :: ABOUT HEALTHSOUTH :: CAREERS :: MY

- QUICK LINKS
- + Resource Center
  - + Healthy Living
  - + Sports Health
  - + Our Services
  - > About HealthSouth
    - Corporate Governance
    - Mission Statement
    - Corporate Officers
    - Board of Directors
    - Patient Satisfaction
    - Privacy Practices
    - Partnerships
    - Press Releases
    - Media Kit
    - Investor Relations
    - Other Web Sites
  - + Careers
  - + My Health
  - Return to Home

**HEALTHSOUTH Chairman Richard Scrusby Cleared By Outside Investigation Of Advance Knowledge Of Medicare Rule Change Prior To Stock Transactions**

BIRMINGHAM, Ala., Oct. 30 /PRNewswire-FirstCall/ – Richard M. Scrusby, Chairman of the Board of HEALTHSOUTH Corporation (NYSE: HRC), was cleared by an outside investigation conducted by a national law firm of all allegations of inside knowledge concerning the impact of a Medicare reimbursement rule change prior to stock and loan repayment transactions in May and July 2002.

Fulbright & Jaworski L.L.P., a national law firm based in Houston, Texas, concluded that Mr. Scrusby had no knowledge of any Medicare reimbursement rule change or its financial impact on the Company until two months after he sold stock on May 14 due to expiring stock options and a week after he had repaid a stock loan on July 31.

Fulbright reached its findings after concluding an extensive six-week investigation that began on September 18. Fulbright's outside review involved interviews with over a dozen key HEALTHSOUTH employees and senior managers, members of the Board of Directors, and others outside the Company and included a review of internal Company email, documents, spread sheets, and other types of electronic data contained in approximately 12,900 documents comprising 119,600 pages, which were in turn derived from a search covering approximately 59,000 documents totaling 546,300 pages.

"This thorough outside review conducted by Fulbright & Jaworski puts to rest any question whether Mr. Scrusby had any inkling or knowledge of the Medicare reimbursement rule change or its impact prior to his stock transactions in May and July 2002," said independent director Robert P. May, chairman of the Board's Special Corporate Governance Committee and Special Litigation Committee.

The Fulbright Report concluded:  
 "...Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby was aware at the time of his option exercise and sale of HEALTHSOUTH common stock on May 14, 2002, of the pending issuance of Transmittal 1753 [the Medicare rule change]. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby knew prior to the time of the transfer by Mr. Scrusby of HEALTHSOUTH common stock to HEALTHSOUTH on or about July 31, 2002, in satisfaction of the principal amount of a loan made to him by HEALTHSOUTH under its 1999 Executive Equity Loan Plan, of: (i) Transmittal 1753 [the Medicare reimbursement rule change]; (ii) the application of Transmittal 1753 [the reimbursement rule change] to the Company's various outpatient therapy services; or (iii) the Transmittal's potential financial effect on the Company."

The Company said that it will continue to cooperate fully in all respects with the SEC in its investigation of these matters, of which the Company was first advised on September 18. The Company had notified the SEC on September 15 that it would fully cooperate in

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HealthSouth: healthcare in surgery, ambulatory, diagnostic and rehab

the event the SEC conducted an inquiry concerning Mr. Scrushy's stock transactions.

"I am pleased by Fulbright's confirmation of the facts and the truth concerning my lack of any knowledge of the Medicare reimbursement rule change prior to my stock transactions," Mr. Scrushy said.

HEALTHSOUTH is the nation's largest provider of outpatient surgery, diagnostic imaging and rehabilitative healthcare services, with approximately 1,900 locations in all 50 states, the United Kingdom, Australia, Canada and Puerto Rico. HEALTHSOUTH can be found on the Web at <http://www.healthsouth.com>.

Statements contained in this press release which are not historical facts are forward-looking statements. Without limiting the generality of the preceding statement, all statements in this press release concerning or relating to estimated and projected revenues, earnings, margins, costs, expenditures, cash flows, growth rates and financial results are forward-looking statements. In addition, HEALTHSOUTH, through its senior management, may from time to time make forward-looking public statements concerning the matters described herein. Such forward-looking statements are necessarily estimates based upon current information, involve a number of risks and uncertainties and are made pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. HEALTHSOUTH's actual results may differ materially from the results anticipated in these forward-looking statements as a result of a variety of factors, including those identified in this press release and in the public filings made by HEALTHSOUTH with the Securities and Exchange Commission, including HEALTHSOUTH's Annual Report on Form 10-K for the year ended December 31, 2001 and its Quarterly Reports on Form 10-Q, and forward-looking statements contained in this press release or in other public statements of HEALTHSOUTH or its senior management should be considered in light of those factors. There can be no assurance that such factors or other factors will not affect the accuracy of such forward-looking statements.

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Hirsch, Hal

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**From:** Gold, Neil  
**Sent:** Thursday, October 31, 2002 9:39 AM  
**To:** Hirsch, Hal; Kaplan, Carl; deButts, Robert; Galant, Felice; Unger, Peter  
**Subject:** CORRECTED - UPDATE 1-Law firm clears HealthSouth chair on share trades.htm

**See Lanny's testimonial to F&J and also his mischaracterization of our findings.  
(We did not state in anything in the report about the August 15 date and when  
Richard learned of full effect of the change.)**



CORRECTED -  
PDATE 1-Law firm .

Tab 82

Hirsch, Hal

From: Hirsch, Hal  
 Sent: Thursday, October 31, 2002 3:28 PM  
 To: W. Horton Williams (E-mail); J. Michael Rediker (E-mail); Krebs Tom (E-mail)  
 Cc: Kaplan, Carl; Gold, Neil

Fyi, see bold in text below:

Tab 83

**USA: UPDATE 1-Law firm clears HealthSouth chair on share trades.**

10/30/2002

Reuters English News Service

(C) Reuters Limited 2002.

NEW YORK, Oct 30 (Reuters) - HealthSouth Corp., which operates medical facilities, on Wednesday said Chairman Richard Scrushy was cleared by a law firm the company hired to investigate insider trading allegations.

The matter of whether Scrushy sold shares of the company ahead of damaging news about Medicare reimbursement rates is still under investigation by the Securities and Exchange Commission.

Fulbright & Jaworski, a law firm HealthSouth hired, found Scrushy had no knowledge of any Medicare reimbursement rule change or its financial impact on the company until after he disposed of nearly 8 million shares.

When asked if the report could be regarded as objective, Davis said, "Fulbright and Jaworski is an international law firm known for its integrity."

Scrushy sold 5.3 million shares in May, which were tied to options that were set to expire, and returned 2.5 million shares to the company in July to forgive a company loan, HealthSouth said.

The company is a provider of physical therapy, outpatient surgery and diagnostic imaging services.

Davis said the Fulbright & Jaworski report said Scrushy did not learn about the existence of the Medicare rule change until Aug. and did not learn that this would affect all of its facilities performing group physical therapy until August 15.

Fulbright & Jaworski is sharing its findings with the Securities and Exchange Commission, said Lanny Davis, who is HealthSouth's outside counsel and an attorney at Washington, D.C. law firm Patton Boggs.

Fulbright's outside review involved 39 interviews with HealthSouth employees and managers, directors and included a review of e-mail, documents, spread sheets, and other types of electronic data comprising 119,600 pages, HealthSouth said.

HealthSouth said on Aug. 27 that it was withdrawing its earnings guidance to investors for the remainder of 2002 and 2003 after changes in Medicare reimbursement for group physical therapy. The company expects the changes to hurt annual earnings before interest, taxes, depreciation and amortization by \$175 million annually.

Companies under these types of investigations hire prestigious law firms and depend on their independence, Davis said, noting there is no prior business relationship between HealthSouth and Fulbright & Jaworski.

**Fulbright & Jaworski found there were problems with lower level executives communicating issues to senior management, specifically about the Medicare rule change, Davis said.**

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 By Dechert LLP on behalf of its client

FJ 010880

HealthSouth's board is evaluating whether disciplinary action should be taken against employees about not bringing the Medicare change to the attention of higher executives, Davis said.

# # #

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
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(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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By Dechert LLP on behalf of its client

FJ 010881

Hirsch, Hal

---

**From:** Gold, Neil  
**Sent:** Thursday, October 31, 2002 3:30 PM  
**To:** Hirsch, Hal; Kaplan, Carl  
**Subject:** RE: CNN clip on HealthSouth

Tab 84

**This is the same article that misquotes the report in at least two material respects. First, our chronology stopped at August 8 and did not address anything about August 15. Second, we did not say anything about communications problems between lower level executives and senior management. (Unless "senior management" only includes Scrushy and "lower level executives" include everyone in the company other than Scrushy.)**

-----Original Message-----  
**From:** Hirsch, Hal  
**Sent:** Thursday, October 31, 2002 3:24 PM  
**To:** Gold, Neil; Kaplan, Carl  
**Subject:** FW: CNN clip on HealthSouth

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
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 hhirsch@fulbright.com

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-----Original Message-----  
**From:** Nicas, Leigh Ann  
**Sent:** Thursday, October 31, 2002 10:23 AM  
**To:** Ford, Michael; Hirsch, Hal  
**Subject:** CNN clip on HealthSouth

<http://money.cnn.com/2002/10/30/news/companies/healthsouth.reu/index.htm>

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 By Dechert LLP on behalf of its client

FJ 010882

**Hirsch, Hal**

---

**From:** Gold, Neil  
**Sent:** Thursday, October 31, 2002 3:32 PM  
**To:** Hirsch, Hal; Kaplan, Carl; Beckler, Richard  
**Subject:** RE: HealthSouth

I guess Adam Goldberg, and not Richard Scrusny, speaks for HealthSouth, unless Lanny talked to Richard after you did this afternoon.

-----Original Message-----

**From:** Hirsch, Hal  
**Sent:** Thursday, October 31, 2002 3:30 PM  
**To:** Kaplan, Carl; Gold, Neil; Beckler, Richard  
**Subject:** FW: HealthSouth  
**Importance:** High

Tab 85

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----

**From:** Hirsch, Hal  
**Sent:** Thursday, October 31, 2002 3:29 PM  
**To:** Unger, Peter  
**Subject:** FW: HealthSouth  
**Importance:** High

Please answer this immediately and then call me.  
-hnh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
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(201) 788-9800 (cell)  
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hhirsch@fulbright.com

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By Dechert LLP on behalf of its client

FJ 010886

-----Original Message-----  
From: Goldberg, Adam [mailto:AGoldberg@PattonBoggs.com]  
Sent: Thursday, October 31, 2002 3:26 PM  
To: Hal Hirsch (E-mail)  
Cc: Davis, Lanny; Sjoquist, Mary  
Subject: HealthSouth  
Importance: High

To clarify my voicemail left in response to your recent e-mail to Lanny and Mary, Fulbright is authorized to release to the SEC only the report delivered to the Board this week, not the earlier portions. Please call me if you have any questions.

This e-mail message contains confidential, privileged information intended solely for the addressee. Please do not read, copy, or disseminate it unless you are the addressee. If you have received it in error, please call us (collect) at (202) 457-6000 and ask to speak with the message sender. Also, we would appreciate your forwarding the message back to us and deleting it from your system. Thank you.

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By Dechert LLP on behalf of its client

FJ 010887

**Melendez, Madelene**

---

**From:** Davis, Lanny  
**Sent:** Thursday, October 31, 2002 3:37 PM  
**To:** Goldberg, Adam  
**Subject:** FW: HealthSouth

**Importance:** High

Tab 86

Please indicate that this instruction pertains to "as of now".

-----Original Message-----

**From:** Goldberg, Adam  
**Sent:** Thursday, October 31, 2002 3:26 PM  
**To:** Hal Hirsch (E-mail)  
**Cc:** Davis, Lanny; Sjoquist, Mary  
**Subject:** HealthSouth  
**Importance:** High

To clarify my voicemail left in response to your recent e-mail to Lanny and Mary, Fulbright is authorized to release to the SEC only the report delivered to the Board this week, not the earlier portions. Please call me if you have any questions.

PB 01852

**Hirsch, Hal**

**From:** Hirsch, Hal  
**Sent:** Thursday, October 31, 2002 3:53 PM  
**To:** Unger, Peter; W. Horton William (E-mail)  
**Subject:** FW: HealthSouth

**Importance:** High

Tab 87

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
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 hhirsch@fulbright.com

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-----Original Message-----

**From:** Goldberg, Adam (mailto:AGoldberg@PattonBoggs.com)  
**Sent:** Thursday, October 31, 2002 3:51 PM  
**To:** Hal Hirsch (E-mail)  
**Cc:** Davis, Lanny; Sjoquist, Mary  
**Subject:** FW: HealthSouth  
**Importance:** High

To follow up on the e-mail below, the authorization to deliver only the report on Chairman Scrushy that you provided the Board this week is as of now. As you know, the Board is still reviewing the other Fulbright reports and will make their decisions with respect to such other reports upon concluding its review.

&gt; -----Original Message-----

> **From:** Goldberg, Adam  
 > **Sent:** Thursday, October 31, 2002 3:26 PM  
 > **To:** Hal Hirsch (E-mail)  
 > **Cc:** Davis, Lanny; Sjoquist, Mary  
 > **Subject:** HealthSouth  
 > **Importance:** High

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 > and Mary, Fulbright is authorized to release to the SEC only the report  
 > delivered to the Board this week, not the earlier portions. Please call  
 > me if you have any questions.

>  
 >  
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 > solely for the addressee. Please do not read, copy, or disseminate it  
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 > us (collect) at (202) 457-6000 and ask to speak with the message sender.  
 > Also, we would appreciate your forwarding the message back to us and  
 > deleting it from your system. Thank you.

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 By Dechert LLP on behalf of its client

FJ 010890

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By Dechert LLP on behalf of its client

FJ 010891

F. J. W. J. J. J.

FULBRIGHT & JAWORSKI L.L.P.  
A REGISTERED LIMITED LIABILITY PARTNERSHIP  
801 PENNSYLVANIA AVENUE, N.W.  
WASHINGTON, D.C. 20004-2623

Tab 88

MEMORANDUM

TO: John Hanson                      ATTORNEY-CLIENT PRIVILEGED MATERIAL  
Robert May                          ATTORNEY WORK PRODUCT

DATE: October 31, 2002

FROM: Richard W. Beckler   
Matthew H. Kirtland

RE: Notice Regarding Document Review

---

At the request of the Board of Directors of HealthSouth Corporation, Fulbright & Jaworski L.L.P. ("Fulbright") conducted a limited review of the shredded material removed from the large shredder in the file room on the fifth floor of the Executive Office Tower. Please find attached photocopies of the shreds that matched our review criteria. This supplements the reference Fulbright made to "mittal 1753" and "175 m" on page 1, paragraph 2 of the October 29, 2002 report to the Board of Directors.

cc: Hal Hirsch  
Peter V.B. Unger  
Carl E. Kaplan  
Neil Gold  
Lanny Davis

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By Dechert LLP on behalf of its client

FJ 003421

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CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 003423

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 By Dechert LLP on behalf of its client

FJ 003424

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CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

FJ 003425

775

**Licon, Doris**

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**From:** Unger, Peter  
**Sent:** Friday, November 01, 2002 9:31 AM  
**To:** Licon, Doris  
**Cc:** Hirsch, Hal  
**Subject:** HS

Please fax Mr. Hirsch copies of the two cover letters to the reports we gave the SEC this week ASAP. Thanks.

\*\*\*\*\*

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To reply to our email administrator directly, send an email to [postmaster@fulbright.com](mailto:postmaster@fulbright.com)

FULBRIGHT & JAWORSKI L.L.P.  
\*\*\*\*\*

**Tab 89**

CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client

1

FJ 006366

Confirmation Report-Memory Send

Time : Oct-31-2002 05:44pm  
 Tel line : 202-662-4643  
 Name : FULBRIGHT & JAWORSKI

Job number : 076  
 Date : Oct-31 05:35pm  
 To : 5278\*10210605\*14048427687  
 Document Pages : 036  
 Start time : Oct-31 05:35pm  
 End time : Oct-31 05:44pm  
 Pages sent : 036  
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 Job number : 076

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FULBRIGHT & JAWORSKI L.L.P.  
 A REGISTERED LIMITED LIABILITY PARTNERSHIP  
 801 PENNSYLVANIA AVENUE, N.W.  
 WASHINGTON, D.C. 20004-2615

COUSIN, S.C.  
 WASHINGTON, D.C.  
 20004-2615  
 TEL: 202-662-4643  
 FAX: 202-662-4643  
 WWW: WWW.FULBRIGHT.COM

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Msgr. A. Seiden	(404) 862-7687	

From: Peter V.B. Duggan Phone No.: Total No. of Pages Sent: (including Cover Sheet)  
 Date: October 31, 2002 User No.: 05278 Pgs: 5 Matter No.: 10210605  
 Return Transmitted Fax To: Margaret H. Kirtland  
 Re:

REMARKS:

*If you experience problems with this transmission or have questions, please call 202-662-0200.*

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SENT FROM FULBRIGHT & JAWORSKI L.L.P.'S FAX CENTER: (202) 662-4643

777

FULBRIGHT & JAWORSKI L.L.P.

TELEPHONE: 202/662-0200  
FACSIMILE: 202/662-4643

A REGISTERED LIMITED LIABILITY PARTNERSHIP  
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WASHINGTON, D.C. 20004-2615

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FACSIMILE COVER SHEET

RECIPIENT(S)	FACSIMILE PHONE NO.	PHONE NO. IN EVENT OF TRANSMISSION DIFFICULTY
Neal A. Seiden	(404) 842-7687	

From: Peter V.B. Unger	Phone No.:	Total No. of Pages Sent: (Including Cover Sheet)
Date: October 31, 2002	User No.: 05278	Fir: 5 Matter No.: 10210605

Return Transmitted Fax To: Matthew H. Kirtland

Re:

REMARKS:

*If you experience problems with this transmission or have questions, please call 202-662-0200.*

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**SENT FROM FULBRIGHT & JAWORSKI L.L.P.'S FAX CENTER: (202) 662-4643**

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By Dechert LLP on behalf of its client

FJ 006368

778

FULBRIGHT & JAWORSKI L.L.P.

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PUNGER@FULBRIGHT.COM  
DIRECT DIAL: (202) 662-4741

TELEPHONE: (202) 662-0200  
FACSIMILE: (202) 662-4643

October 31, 2002

Via Facsimile Transmission (404) 842-7687

FOIA Confidential Treatment Requested

Mr. Neal A. Seiden  
Atlanta District Office  
United States Securities and Exchange Commission  
3475 Lenox Road, N.E., Suite 1000  
Atlanta, GA 30326-1232

Re: In the Matter of HealthSouth Corporation File No. MA-02772

Dear Mr. Seiden:

On September 18, 2002 HealthSouth Corporation ("HealthSouth" or the "Company") and its Board of Directors engaged Fulbright & Jaworski L.L.P. (or "F&J") to conduct a review of the company's disclosures and related events (the "review"). In light of the interest of the staff of U.S. Securities and Exchange Commission (the "staff") in determining whether there have been any violations of the federal securities laws and the company's interest in investigating and analyzing the circumstances and people involved in the events at issue, the Company is providing the staff a copy of two documents:

(1) F&J's review memo dated October 21, 2002 regarding whether (i) at the time of the exercise of options and sale of HealthSouth common stock by Richard M. Scrusby on or about May 14, 2002 or (ii) at the time of transfer of HealthSouth Common Stock to the Company by Mr. Scrusby in satisfaction of the principal amount of a loan from HealthSouth on or about July 31, 2002, Mr. Scrusby was aware of the potential financial effect on the Company of Transmittal 1753 of the Centers for Medicare and Medicaid Services to the Medicare Carriers Manual, specifically the language "added to clarify payment policy for group therapy services;" and

(2) F&J's review memo dated October 29, 2002 regarding the facts and circumstances relating to the destruction of documents at HealthSouth subsequent to the receipt on September 17, 2002 of a request from the staff for certain documents pertaining to an investigation of HealthSouth's August 27, 2002 announcement.

Please be advised that by producing the confidential materials pursuant to this agreement the Company does not intend to waive the protection of the attorney work product doctrine,

30354857.1

**CONFIDENTIAL TREATMENT REQUESTED**  
**By Dechert LLP on behalf of its client**

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FJ 006369

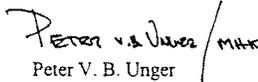
Mr. Neal A. Seiden  
October 31, 2002  
Page 2

attorney-client privilege or any other privilege applicable as to third parties. The Company believes that the confidential materials are protected by, at a minimum, the attorney work product doctrine, and the attorney-client privilege. The Company believes that the confidential materials warrant protection from disclosure.

The staff will maintain the confidentiality of the confidential materials pursuant to this agreement and will not disclose them to any third party, except to the extent that the staff determines that disclosure is otherwise required by law would be in furtherance of the Commission's discharge of its duties and responsibilities. The staff will not assert that the Company's production of the confidential materials to the Commission constitutes a waiver of the protection of the attorney work product doctrine, the attorney-client privilege or any other privilege applicable as to any third party. The staff agrees that the production of the confidential materials provides the staff with no additional grounds to subpoena testimony, documents or other privileged materials from the company, although any such grounds that may exist apart from such productions will remain unaffected by this agreement.

The staff's agreement to the terms of this letter is signified by your signature on the line provided below.

Very truly yours,

  
Peter V. B. Unger

Agreed and accepted by  
United States Securities and Exchange Commission

---

Division of Enforcement

**From:** Horton, Bill  
**Sent:** Saturday, November 2, 2002 12:12 PM  
**To:** Scrushy, Richard Tab 90  
**Subject:** FW: Confidential and Privileged

---

See below. Lanny wants me to call him. Before I do, I wanted to know if we were still fighting over this, or if the message below is just Lanny being Lanny. Please email or call me in the office (969-4977) and let me know where you are on all this. Thanks.

-----Original Message-----  
From: Davis, Lanny [mailto:LDavis@PattonBoggs.com]  
Sent: Saturday, November 02, 2002 10:35 AM  
To: Horton, Bill  
Subject: Fw: Confidential and Privileged

FYI--please page me ayc over weekend.

-----Original Message-----  
From: Davis, Lanny <LDavis@PattonBoggs.com>  
To: 'hhirsch@fulbright.com' <hhirsch@fulbright.com>  
Sent: Sat Nov 02 11:17:01 2002  
Subject: Confidential and Privileged

Privileged: Attorney Client and Work Product

To: Hal Hirsch Esq., Fulbright and Jaworski LLP

From: Lanny J Davis, Patton Boggs LLP

Date: Saturday, Nov. 2, 2002

Per your request, this is to notify you that Mr. Scrushy has reluctantly agreed to put the press release out, per the last version you sent me last night. He asked me to inform you and your firm that the only reason he agreed to do so is that Fulbright demanded that he do so, that he does not believe it is necessary to do so, that he does so very unhappily, and that he believes the Board of Directors will share his unhappiness about being forced to do this by Fulbright.

As you know, Patton Boggs, representing the unanimous views of numerous

senior partners with expertise in these matters, entirely agrees with Mr Scrusby and advised him that this release advanced by Fulbright for publication is neither necessary nor advisable. We therefore urge Fulbright to reconsider and withdraw its demand. If for any reason Fulbright withdraws its demand, please notify me by Sunday evening, Nov. 3, no later than 6 pm. After that time, HealthSouth has informed me it will issue the release as Fulbright has demanded.

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To learn more about our firm, please visit our website at <http://www.pattonboggs.com>.

782

**FULBRIGHT & JAWORSKI L.L.P.**

A REGISTERED LIMITED LIABILITY PARTNERSHIP  
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HHIRSCH@FULBRIGHT.COM  
DIRECT DIAL: (212) 318-3105

TELEPHONE: (212) 318-3000  
FACSIMILE: (212) 318-3400

Tab 91

**DRAFT**

November 5, 2002

**PRIVILEGED AND CONFIDENTIAL:  
ATTORNEY-CLIENT COMMUNICATION**

**BY EMAIL and FAX**

Richard M. Scrushy  
Chairman of the Board  
HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, AL 35243

Dear Richard:

FTI Consulting is completing its draft written analysis in regard to HealthSouth Corporation's announcement on August 27, 2002 that as a result of CMS Transmittal 1753, the Company's EBITDA "will be lower than previously projected by approximately \$175 million annually." FTI Consulting proposes to furnish its draft analysis to certain Company personnel, specifically Bill Owens, Susan Smith, Rick Schmitt and Frank Dicesare, for these individuals to confirm certain assumptions underlying the methodology used before the analysis is finalized for general distribution and use. Please let me know if you approve or disapprove of FTI Consulting providing its draft analysis to these Company personnel for their review and comment before the document is finalized.

Very truly yours,

Hal M. Hirsch

HH/im

**CONFIDENTIAL TREATMENT REQUESTED**  
**By Dechert LLP on behalf of its client**  
20046928.1/10210604

**FJ 000262**

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**Melendez, Madelene**

**From:** Davis, Lanny  
**Sent:** Thursday, November 07, 2002 8:00 PM **Tab 92**  
**To:** 'Hirsch, Hal'  
**Cc:** Richard M. Scrusby (E-mail); Sjoquist, Mary; Peter Unger (E-mail)  
**Subject:** RE: HealthSouth

In reply to your reply to Mr. Scrusby's comments in response to the four demands as conditions to Mr. Unger's continued representation of the company before the SEC:

1. Mr. Scrusby reiterates that you should communicate through counsel, not directly to him. You do not have to worry about emails being forwarded to Mr. Scrusby that are appropriate. Please respect his wishes.
2. Thank you and agreed.
3. You are free to transmit whatever work product you wish regarding the CMS information. The position Mr. Scrusby stated as per my prior email rejecting this demand for additional payments has not changed.
4. As previously stated, Mr. Scrusby is not in a position to make "immediate" satisfaction of outstanding invoices until he (and I) can review such invoices, which I asked you to transmit to me immediately.

Time is of the essence regarding legal representation activities and communications with respect to the SEC investigation. Thus, based on the earlier email and this one, please let me know first thing in the morning whether Mr. Unger is able to continue the representation. We would be very disappointed if the answer to that question is no, but we need to know immediately.

Thank you for your earliest reply.

-----Original Message-----

**From:** Hirsch, Hal [mailto:hhirsch@fulbright.com]  
**Sent:** Thursday, November 07, 2002 5:26 PM  
**To:** 'Melendez, Madelene'; Lanny Davis (pager) (E-mail); J. Davis Lanny (E-mail)  
**Cc:** 'rscrusby@healthsouth.com'; 'Mary.Esclavon@healthsouth.com'; Unger, Peter; Sjoquist, Mary  
**Subject:** RE: HealthSouth

I am in part confused by your response and invite a call if you like. Otherwise, and particularly in light of Sarbanes-Oxley, please note the following:

- 1) Fulbright & Jaworski, LLP was retained by the Board of Directors and, respectfully, not Patton Boggs and therefor must communicate to its client concerning the terms of its engagement; we are willing to discuss these matter through Patton Boggs but the client must be directly involved. Hence, copies to Richard Scrusby;
  - 2) We do not have any problem with Patton Boggs working as co-counsel with Fulbright & Jaworski, LLP, so long as Fulbright is free to counsel and represent the client as it deems to be in the client's best interests;
  - 3) Fulbright & Jaworski, LLP has been engaged by the Board of Directors of HealthSouth to perform a CMS review. Fulbright & Jaworski, LLP has gathered data and knowledge which it is now required to report to the Company. This can be done in a number of ways, but it must be provided. We will discuss this further if desired; and
  - 4) In the event that there is not immediate satisfaction of the Fulbright & Jaworski, LLP invoice, we will be unable to continue with the representation of HealthSouth regarding the SEC investigation.
- hnh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP

PB 01776

9/17/2003

666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
 (212) 318-3400 (fax)  
 nhirsch@fulbright.com

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-----Original Message-----

**From:** Melendez, Madelene [mailto:MMelendez@PattonBoggs.com]

**Sent:** Thursday, November 07, 2002 4:37 PM

**To:** 'nhirsch@fulbright.com'

**Cc:** 'rscrushy@healthsouth.com'; 'Mary.Esclavon@healthsouth.com'; 'punger@fulbright.com'; Sjoquist, Mary

**Subject:**

*In response to your recent E-mail: (1) We accept this condition with the understanding that Peter Unger will work with Patton Boggs in all matters relating to the SEC & will only communicate with us and Mr. Scrusby and nobody else concerning all legal strategic issues, as per my discussion with Peter yesterday. (2) Under no circumstances can or will we accept this condition. All work other than Mr. Unger's will cease immediately, as per the E-mail I was directed to send you yesterday. (3) We agree to your condition regarding obtaining the written consent of Fulbright concerning any press comments characterizing Fulbright's position. As you know, we strictly adhered to that condition and do indeed have such written consent from you with respect to the press release concerning Mr. Scrusby's clearance after the completion of the Fulbright investigation. And (4) Mr. Scrusby has asked me to review all of Fulbright's bills including all attachments & attorney diaries and disbursements. Please transmit them to me as soon as possible. He is out of town until next Tuesday at which time I will meet with him and offer recommendations. I am confident that we will be able to resolve the issue of payment for appropriate legal services rendered to Fulbright's satisfaction. Finally, Mr. Scrusby has asked me to instruct you, for the third and hopefully last time, not to communicate directly with him but rather only through Patton Boggs. That includes phone calls and E-mails. As I previously indicated, these are Mr. Scrusby's instructions and I am asking you to respect them. Moreover, I ask for your confirmation that you will respect this instruction.*

*If you have any questions or comments, and cannot reach me, please call Mary Sjoquist as I previously had indicated.*

*If the above response will not permit Peter Unger to continue representing HealthSouth at the SEC, please inform me of such fact immediately so that we can arrange for a smooth transition.*

*Maddie Melendez  
 Assistant to Lanny J. Davis  
 Patton Boggs LLP  
 2550 M Street, N.W.  
 Washington, D.C. 20037  
 mmelendez@pattonboggs.com  
 202-457-5226  
 202-457-6482 (Fax)*

PB 01777

9/17/2003

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PB 01778

9/17/2003

**Harvey, Jason**

---

From: Scrusby, Richard  
 Sent: Friday, November 08, 2002 9:15 AM  
 To: Harvey, Jason  
 Subject: Fw: RE: Thank You

Tab 93

Keep this to yourself. Thanks rs

-----  
 Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

-----Original Message-----

From: Hirsch, Hal <hhirsch@fulbright.com>  
 To: Scrusby, Richard <rscrusby@healthsouth.com>  
 Sent: Fri Nov 08 07:38:24 2002  
 Subject: RE: Thank You

THESE ARE THOUGHTS OF HAL HIRSCH AND NOT FULBRIGHT & JAWORSKI, LLP - TAKE THEM AS YOU LIKE.

Richard:

Like or believe it or not, I have always been there for you and your company and have suffered greatly for it. Your reactions to all that has happened in regard to all that you and the Company have been through is a direct reaction to your relying upon the promise of Lanny Davis that the media and his vision will be your magic bullet. He seems to tell you what you want to hear and when it does not work out he seems to find a fall guy. He has convinced you now that it is me. That is because Lanny Davis FILTERS everything that you hear. Ever wonder why he had mouths all of your people including officers, lawyers and new directors. The billing issues arose because Davis advised that HE would determine how much and if we got paid. From the start Davis has tried to USE the reviews as media props not as you had desired to find out the truth. If they were used as corporate America uses them and the SEC views them then your release and media statements would have said something like, "Scrusby Unaware of 1753 when he sold his stock." That is what we said. Other than being in the Clinton White House as a 'Lawyer' what do you think his media training and experience is? I do not know - do you? Who brought the New York Times to your home? Lanny Davis just did to me on Tuesday with the New York Times what he did to you. I started a business called Corporate Diagnostic with Kemp, Marsh McClellan and others which Davis destroyed in the press. I am dropping out of due to the embarrassment. Listen to your other advisers and get some distance from Davis, you and your company need it. My work is and has been your salvation, particularly given how well the reviews have been received by the SEC. Their use in the media has been dumb but you refuse to listen to anyone but Davis. Why. Please open you ears to the other great advisors you have - new and old - other than me. Davis may wish to push Rediker and others away but they are smart and not under Davis' influence. KEEP YOUR OWN COUNSEL. Did you ever REALLY do diligence on Davis' other clients before you fell under his spell? I have been representing billion dollars companies and have worked out the problems of HUNDREDS OF COMPANIES BUSINESS, LEGAL AND FINANCIAL PROBLEMS FOR OVER 20 YEARS; how many do you think Davis has worked out. I have tutored Davis as to why I cannot withdraw from the SEC representation of HS because it would devastate HS and the capital markets, not to speak of what the SEC, DOJ, FBI and other will think and the confidence that may be lost. Nonetheless, Davis pushes us out. Do you know why: THE MEDIA GAME HAS BEEN A FAILURE. Even the media itself says that. Davis must blame someone. The review is as good a result as any company in this environment could have as a tool. But it is just a tool not magic. The media is not your friend. They make money by writing about problems - you know that. The last vestige of the CMS report tells nothing of you but what your employees knew; THE EXACT INFORMATION THAT YOU AND THE BOARD WANT SO BADLY. Maybe Davis' problem is that the report will NOT blame the employees as he has suggested. You have told me so many times how you need these people. When Davis filters my statements and access to you, as he does with so many other, how do you know what is even going on? My invoice is in your office. I only pushed payment because Davis said that we would NOT get paid. You just do not know how Davis is perceived to be running you behind your back. He wanted Bob May and the outside Lead Director to 'help' run YOUR COMPANY. Do you remember calling me so many times troubled by this. Who is screaming

transparency when the press is blaming 'bad press' on the HealthSouth problems. NOTE THAT EVERY TIME I SPEAK OR WRITE TO YOU, YOU EITHER TELL DAVIS OR SEND HIM A COPY OF IT. HE THEN TELLS YOU WHY HE IS RIGHT AND WHAT YOU SHOULD SAY - HE SPINS YOU. I have abandoned Corporate Diagnostics, a \$20-50 million PRE SOLD business idea that I started in June that is just now taking off. I am going to severely limit my role in HealthSouth. This is all because of Davis looking out for Davis. I am distancing myself from him as I am tired of being professionally and emotionally hurt by him. I never wanted anything from you and never wanted any glory or press for myself or my Firm. All you ever got from me was damn good advice and results. Even the best bottle of wine is crap if you put it into a cracked glass. You need to VERIFY Davis' advice with others. I suggest ANYONE though since Rediker has all the facts and is lead of your litigation team, that might be a good place to start. I would appreciate you not sharing my counsel to you with others as IT WILL JUST MAKE MY BLEEDING ULCER A GREAT DEAL WORSE. If by some fluke you wish to talk to me you are always welcome to call - even on the weekends. I hope that you and your wonderful family are well.

-hnh

Hal M. Hirsch, Partner  
 Fulbright & Jaworski, LLP  
 666 Fifth Avenue  
 New York, New York 10103  
 (212) 318-3105 (dir.)  
 (201) 788-9800 (cell)  
 (212) 318-3400 (fax)  
 hhirsch@fulbright.com

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-----Original Message-----  
 From: Scrushy, Richard [mailto:rscrushy@healthsouth.com]  
 Sent: Friday, November 08, 2002 7:18 AM  
 To: 'hhirsch@fulbright.com'  
 Cc: 'ldavis@pattonboggs.com'  
 Subject: Thankyou

Hal as the chairman of the Board of Directors of Healthsouth I am informing you that we the Board have decided that we have all the information we need relative to the reweiv your firm was performing on our company. The 100000 dollars is more than we want to spend for additional review. Have Tom drop me a note as to what his report would give us. I would like for you to send me directly any information you have to date that you expect us to pay for. After reweiv I will let you know if we want any additional information. I am very unhappy with your forcing this last press release and the way you handled the letters after the reweiv. There should be no more billing us on the reweiv to include FTI. Send me what you have and return all files and property except things that peter ungar needs for his work with the S.E.C.. I would like to think you would be big enough to understand and respect our position and decisions without destroying the opportunity to have have a future relationship. I will be back in the office on tuesday and I will reweiv your invoice then and if I believe it is in order I will process for payment as we pay all other bills. Where is your bill? I have not seen it. Did you send it to me. This noise you made in the last few days demanding payment really makes me mad as hell. We pay our bills. You know this and this bickering is unnecessary. Hal I need to give you a little advice about winning friends and influencing people. I have had it with your running over me and demanding Board Meetings. If I called a board meeting to just discuss something you forced on me what do you think the vote would be? I have been the Chairman for 19 years. Now send me your bill and I will take care of it next week and send me any additional information you have and stop the clock on the reweiv. If you want to throw another one of your tantrums and not let us work with peter than please transition in a professional way. You see the threats of last week were just too much. Richard

**Dowdell, Tom**

Tab 94

**From:** Hirsch, Hal  
**Sent:** Friday, November 08, 2002 1:14 PM  
**To:** 'deborah.smith@fticonsulting.com'  
**Cc:** Kaplan, Carl; Dominic DiNapoli (E-mail); Gold, Neil; Unger, Peter; Dowdell, Tom  
**Subject:** RE: FW: Thank you

Debbie:

I have advised Richard today of all that is in your note to me. He still wants the report, as it is, to him. I have advised that payment is a prerequisite. He has stated that he will return to the office Tuesday and review both the FTI and F&J invoices then. Apparently, the invoices going to Bill Horton of late have not been considered as Bill Horton is in disfavor. I will follow this personally; enjoy the weekend.  
-hmh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
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New York, New York 10103  
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hhirsch@fulbright.com

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-----Original Message-----

**From:** deborah.smith@fticonsulting.com [mailto:deborah.smith@fticonsulting.com]  
**Sent:** Friday, November 08, 2002 12:41 PM  
**To:** hhirsch@fulbright.com  
**Cc:** Kaplan, Carl; Dominic DiNapoli (E-mail); Gold, Neil; Unger, Peter; Dowdell, Tom  
**Subject:** Re: FW: Thank you  
**Importance:** High

**PRIVILEGED AND CONFIDENTIAL  
ATTORNEY WORK PRODUCT**

Hal,

As we discussed yesterday on the phone, we were trying to set up meetings next week to review the draft with management. No one at HealthSouth has seen this draft report in writing to review or comment on its content. Based upon management's review and their comments, there could be changes to our draft findings. If Richard requires the draft report now, please made clear to him that his management has not reviewed or commented on it.

As you know, this report required a significant undertaking by our staff. To date we have only received our retainer of \$250,000 and have invoices outstanding for fees and expenses in the amount of \$1,453,630.12 which represents all our billings from inception of the engagement on September 18 through November 5. It is our policy that we be brought current on our outstanding bills before any draft reports are released.

We have sincerely enjoyed working with your firm on this engagement and will wait on scheduling meetings

11/08/2002 **CONFIDENTIAL TREATMENT REQUESTED  
By Dechert LLP on behalf of its client**

FJ 003036

with HealthSouth management to review the draft report until we receive further guidance from you to go forward.

Regards,

Dom and Debbie

---

Deborah M. Smith  
Senior Managing Director  
FTI Consulting, Inc.  
1177 Avenue of the Americas  
New York, New York 10036  
646-471-2313  
deborah.smith@fticonsulting.com

"Hirsch, Hal"  
<hhirsch@fulbright.com>  
11/08/2002 11:25 AM

To: Dominic DiNapoli/US/FTIBRS@FTIBRS, Deborah Smith/US/FTIBRS@FTIBRS  
cc: "Unger, Peter" <punger@fulbright.com>, "Dowdell, Tom" <tdowdell@fulbright.com>, "Gold, Neil" <ngold@fulbright.com>, "Kaplan, Carl" <ckaplan@fulbright.com>  
Subject: FW: Thank you

Other than getting paid for your services, which I will tend to, do you have any problems with this instruction for Richard Scrushy.  
-hnh

Hal M. Hirsch, Partner  
Fulbright & Jaworski, LLP  
666 Fifth Avenue  
New York, New York 10103  
(212) 318-3105 (dir.)  
(201) 788-9800 (cell)  
(212) 318-3400 (fax)  
hhirsch@fulbright.com

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-----Original Message-----

**From:** Scrushy, Richard [mailto:rscrushy@healthsouth.com]  
**Sent:** Friday, November 08, 2002 11:23 AM  
**To:** 'hhirsch@fulbright.com'  
**Subject:** RE: Thank you

Just submit fti as is now to me. Looking forward to note from tom on cms. Thanks rs

Sent from my BlackBerry Wireless Handheld (www.BlackBerry.net)

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11/08/2002

**CONFIDENTIAL TREATMENT REQUESTED**  
**By Dechert LLP on behalf of its client**

FJ 003037

**Goldberg, Adam**

---

Tab 95

**From:** deborah.smith@fticonsulting.com  
**Sent:** Tuesday, November 12, 2002 3:01 PM  
**To:** LDavis@pattonboggs.com  
**Cc:** Goldberg, Adam; Dominic.dinapoli@fticonsulting.com; Sjoquist, Mary  
**Subject:** Re: Fw: HealthSouth

Lanny, Adam and Mary,

As requested, attached please find our estimated fees to complete.

Regards,

Debbie Smith

---

Deborah M. Smith  
Senior Managing Director  
FTI Consulting, Inc.  
1177 Avenue of the Americas  
New York, New York 10036  
646-471-2313  
deborah.smith@fticonsulting.com

PB 02379

9/15/2003


**Fee Estimate for Remaining Tasks**

<u>Task</u>	<u>Estimated Fees and Expenses</u>
Unbilled actual time from November 6, 2002 through November 12, 2002.	\$ 24,756
Presentation of the FTI report by Dom DiNapoli, Debbie Smith and Martin Cohen to the Board of Directors.	18,000
Review of the FTI report by Debbie Smith and Martin Cohen with management and minor edits to the report to incorporate management's comments and feedback.	19,000
Comparison of the Company's actual third-quarter outpatient therapy results with last year and with FTI's findings: Reconciliation of outpatient therapy net revenue, including changes in contractual allowances and other reserves; Comparison of 3Q2002 coding / billing patterns with 3Q2001; Comparison of 3Q2002 coding / billing patterns with FTI's re-coded sample data; 3Q2002 monthly coding / billing analysis.	42,000
Analysis of the Company's reported outpatient therapy referral and visit volume trends: Analyze change in referral (admission) volume between 3Q2002 and 3Q2001; Analyze change in visits per discharge between 3Q2002 and 3Q2001; Analyze change visits per therapist FTE between 3Q2002 and 3Q2001.	13,000
<b>Total Remaining Fees and Expenses</b>	<b><u>\$ 116,756</u></b>

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TREATMENT REQUESTED

HEALTHSOUTH Corporation  
MEETING OF THE BOARD OF DIRECTORS  
NOVEMBER 13, 2002  
MINUTES                      Tab 96

A meeting of the Board of Directors of HEALTHSOUTH Corporation (the "Corporation") was held in the Board Room at the Corporation's offices in Birmingham, Alabama pursuant to a Waiver of Notice dated November 13, 2002, a copy of which is attached to these Minutes.

The following Directors were present, constituting a quorum: Richard M. Scrushy, Chairman of the Board of the Corporation, William T. Owens, President and Chief Executive Officer of the Corporation, John S. Chamberlin, Phillip C. Watkins, M.D., George H. Strong, C. Sage Givens, Charles W. Newhall, Larry D. Striplin, Jr., Joel C. Gordon, Robert P. May and Jon F. Hanson. The following guests were also present: Brandon O. Hale, Executive Vice President — Administration and Secretary of the Corporation, William W. Horton, Executive Vice President and Corporate Counsel of the Corporation, Jason Hervey, Senior Vice President — Media and Communications of the Corporation, Swaid N. Swaid, M.D., Medical Director of HEALTHSOUTH Medical Center, Lanny J. Davis of Patton Boggs, LLP, Herbert A. Denton of Providence Capital, and Michael Nicholais of Stephens, Inc.

Richard M. Scrushy acted as Chairman of the Meeting and Brandon O. Hale acted as Secretary.

The Meeting was called to order by Mr. Scrushy at 10:05 a.m. C.S.T.

The Meeting began with an introduction of the members of the Board of Directors, with each one giving a summary of his/her background and length of service on the HEALTHSOUTH Board.

Mr. Denton presented to the Board a summary of his background and his reasons for being there. Mr. Denton stated that he felt Wall Street has a lack of confidence in the Corporation and that he is interested in raising confidence of all constituencies. Mr. Denton stated that he had no magic wand but felt the Board should reconfigure itself to be truly independent of management. According

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TREATMENT REQUESTED

to Mr. Denton, he and his firm had input in placing 33 new directors on the Boards of 18 different companies. He felt that HEALTHSOUTH should add "3, 4 or 5 new directors". Considerable discussion continued between Mr. Denton and members of the Board.

#### **Medical Director Presentation**

Dr. Swaid presented to the Board a physician perspective on how to deal with issues currently facing the Corporation. Dr. Swaid felt that it was critical that the physician community stay motivated, energized and loyal to HEALTHSOUTH, and stated that most physicians wanted Mr. Scrusby to be the leader through the current crisis and to be more visible in that role.

After Dr. Swaid's presentation, general discussion continued regarding Mr. Denton, with additional comments and analysis from Lanny Davis. Also discussed with regard to changes or additions to the Board of Directors were covenants in the Corporation's current credit facility that would not allow a change of the majority of the HEALTHSOUTH Board.

#### **CEO Update**

Mr. Owens provided the Board with an update on the budget process for 2003. He stated that the first and second versions have been revised and the third and final cut is almost complete. Final 2003 budgets will be presented to the Board within the next two to three weeks, with guidance to the markets by mid-December.

Mr. Owens stated that third quarter earnings were not good and that the Corporation is building from there. Mr. Owens advised the Board that the 2003 budgets included significant cuts in expenses and that the Corporation would put out a press release next week advising of a reduction in workforce equal to 1% to 2% of total employment.

#### **SEC Update**

Mr. Davis updated the board on activities involved with the SEC investigation. The Board discussed continuing to use Peter Unger with the law firm of Fulbright & Jaworski in conjunction

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TREATMENT REQUESTED**

with Lanny Davis on SEC matters. At this time Fulbright & Jaworski's services would cease on all other matters.

After discussion, upon motion duly made by Dr. Watkins and seconded by Mr. May, the following resolution was unanimously adopted:

**RESOLVED**, that the continued engagement of Fulbright & Jaworski, L.L.P. to represent the Corporation in connection with ongoing Securities and Exchange Commission activities is hereby authorized and approved.

Mr. Scrusby advised the Board that the Corporation had engaged Stephens, Inc. and Bank of America as additional advisors.

**Special Litigation Committee Report**

Mr. May provided a report on the Special Litigation Committee. He advised that the Committee had sought stays of proceedings in various derivative actions and the Committee had asked the courts for five months to provide its findings. Mr. May also advised the Board that a Delaware firm had been hired to represent the Corporation on related Delaware cases.

**Corporate Governance Committee**

Mr. May reported to the Board that a semi-final draft of the Corporate Governance Charter had been completed and was being reviewed. He also requested that Board members respond as soon as possible with comments on the Insider Trading Policy.

**Compliance Committee**

Dr. Watkins reported that the Compliance Committee met prior to the Board Meeting and reviewed with Messrs. Hale and Douglas the hotline statistics, as well as an update on compliance with the Corporate Integrity Agreement. The Committee also reviewed the results of the HCAR audits and other Compliance Department initiatives.

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TREATMENT REQUESTED

**Audit Committee Report**

Mr. Strong provided the Board with a report of the Audit Committee meeting held prior to the Board meeting. The Committee met with Ernst & Young to review the audit planning process and the scope of the 2002 audit. Mr. Strong advised that the 2002 audit would be more complex, involve more time and be more expensive. The Committee reviewed recently proposed regulations which would require changes in the Audit Committee and its charter. They also reviewed several post-Enron items as they might relate to HEALTHSOUTH (e.g. FIN 44, off-balance sheet items, 401(k) plan issues).

The Audit Committee also met with Greg Smith, Vice President — Internal Audit, without management and in private with Ernst & Young.

The Audit Committee advised Ernst & Young that any consulting services or additional non-routine assignments that they are requested to perform must be submitted to the Audit Committee for review and approval.

**Compensation Committee Report**

Mr. Chamberlin provided a report on the Compensation Committee. The Committee approved the following fees for Board committees and advisors:

Special Litigation Committee

In-person Meeting	\$2,500
Telephone Meeting	\$1,000

\*Advisors to Corporate Governance Committee

Retainer	\$25,000/yr
In-Person Meeting	\$2,500
Telephone Meeting	\$1,000

\* One-year engagement, cancellable with 30 days notice.

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TREATMENT REQUESTED

Mr. Chamberlin also advised the Board that the Committee would seek input from outside compensation consultants to assure that the Corporation maintained a competitive fee structure in comparison to similar corporations.

After discussion, upon motion duly made by Mr. Chamberlin and seconded by Dr. Watkins, the Board of Directors unanimously approved the fees outlined above.

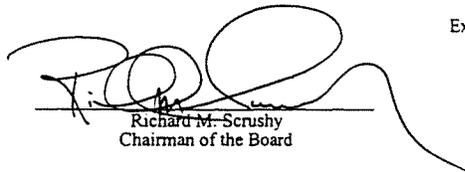
**Other Business**

The Board continued discussion on strategy to deal with Mr. Denton and Providence Capital. Mr. Scrusby provided an update on the *qui tam* litigation and made additional comments on guidance to be provided for 2003 and cost reductions efforts underway.

Mr. Scrusby and Dr. Watkins advised the Board that they had met with William Paul, former Corporate Counsel for Phillips Petroleum and former President of the American Bar Association. Mr. Paul will be engaged to conduct a review of HEALTHSOUTH's Legal Services Department as requested by the Board of Directors.

Mr. Gordon requested reimbursement for legal fees be incurred for outside counsel while serving as Chairperson of the Compliance Committee. The Board approved this request.

There being no further business to transact, the Meeting was adjourned.

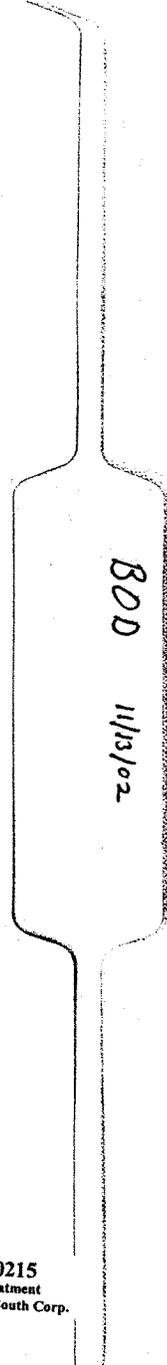


Richard M. Scrusby  
Chairman of the Board



Brandon O. Hale  
Executive Vice President - Administration  
and Secretary

Tab 97



**HHEC 293-0215**  
Confidential Treatment  
Requested by HealthSouth Corp.

Tom Krebs  
254-1416

~~Gay Franklin  
for James Price  
Alaska~~

Burt Denton  
Mike Nicholas  
↳ Stephens?

Dent Denton  
Mike Nicholas

HR  
Risk Mgt  
Copy Copies  
Island Services  
Paper custody shipped

HealthSouth Board

4/13/02

RAS, WTO, GHS, LRS, PCW  
JSC, RPM, JFH, JCG, CHA  
CSG

Guest: B. Allen, B. Hester, J. Henry  
S. Seward, Larry Davis,  
Burt Deaton, Mike Nicholas

9:05 - called to order

Introductions of Directors & Guest

Introductions of Burt Deaton - President Capital

- gave his background
- Reason for being here

↳ Will start his lack of confidence  
in Company & we are indebted  
in raising confidence of all constituencies -

- No Major Ward here
- Feels Board should recognize  
itself to be truly independent  
of Management

"The company has to resolve to right itself"

Director  
of Directors  
SF 33  
SF 35  
Director  
Boards

- I believe we can help HealthSouth find Directors who would help HealthSouth achieve good results

Burke → add 3, 4, or 5 new directors

Swand v. Swand Corporate Medical Director

Slides

- Physician Benefits Once Reviewed
- Refer to various senior divisions
- Central that Physician community stay motivated and engaged

\* How to deal with a Crisis situation Leadership

↳ and the ~~management~~ physician community wants RW to be the leader of this crisis, to be more visible in that role -

"Encourage physician base + their loyalty to HealthSouth"

Questions For Dust Denton

File General discussion with comments  
From Larry Davis

Darryl Leach Bill Owen / Bill Hader discussed  
Dust concerns that would not  
allow us to change more the  
a majority of our board

HHEC 293-0219  
Confidential Treatment  
Requested by HealthSouth Corp.

CEO update - Bill Owen

- Focus on budgets for 02
- Budgets coming in - received 2  
3<sup>rd</sup> cut coming in
- Budget to board in next 2+  
weeks
- Guidance by mid Dec
- Earnings not good for 3<sup>rd</sup> qtr
  - We are building for those
- We continue to see strong business

independen from AGT standpoint

- budgets include significant cuts in expenses
- with reality press within next week
- Short term \$50 mil
- Next year \$50 mil



SEC - update - Henry Davis  
 Peter Ungerly meeting with Henry on SEC

- Question - do we want to continue using F&S or any other investigations

NO  
 Withins  
 May

HRC has engaged Stephens Co + Bank of America as ~~advisors~~ additional advisors

BoFA

SKC Policy

- Stays put in place with courts on various discrimination actions
- We asked courts for examples to make findings
- Delauney firm had to report on

Governance

- Semi-Final draft on Code Gov completed
- Has not received feedback on Insider Trading Policy

Compliance Committee

Report - Phil Wittkins  
 Hethine Stats  
 Compliance Update  
 HCAR Stats

mand to accept rights  
 Wittkins @  
 stop @

Audit Committee Report

George Story -  
 Audit ~~not~~ now more complex, involving  
 more time and more expense

- Revised charges necessary in regard  
 to the Audit Committee and its Charter

- Split time reviewing Post-Coron hot items

FIN 44

JFF Delane shut this

401K - etc

- Review with internal auditors without  
 Mgt

- Review in private with Ety without  
 Mgt - Ety resisted the ~~idea~~  
 fact that audit is more complex  
 + discussed last minute change

- Any consulting Ety is requested to  
 do or additional non-routine assignment  
 will be submitted to Audit com

① Keith

② Stephen

Corporate Committee

SLC 2500 / month  
 1000 / telephone meeting (Full meeting)  
 - minutes required for meeting

Outside Advisors to Corporate Governance

25,000 retention / yr  
 2500 / Full Meeting  
 1000 / phone Meeting

1 year agreement cancellable within  
 30 days notice

- Need info from Mercer

- Propose using these amounts until  
 sign-off from Mercer

- Committee has authority to act for  
 Board if Mercer does not continue

- ① checks
- ② minutes

- Continue discussion on Denton

- Strategy - have Bob, Jon + Jack negotiate with him (Denton)

RMS Am-Tam Update

We only booked \$100 mil  $\oplus$  in the period - exposure possibly \$900 last case to \$20-25 million worse case.

My name  
on the  
list Michael

- looks positive

- Gordon for 03 will be positive qtr by qtr buildup

- grow where we can

- cut costs

- May Direct Max. Haydel

- Get Denton to ultimately sign off on slate of Directors

Met Issues

We have talked with

(Dr. Walter)

William Paul (Former Phillips Petroleum)  
Former President of American Bar Assoc

- In Dept review of legal Dept  
+ <sup>evaluate</sup> ~~recomm~~ General Counsel +  
help us find one if needed

Soed Gordon

- Asked Board to pick up  
legal fees incurred for counsel  
while serving as Chairman of  
Compliance Committee. Board approved.

Executive Session

HealthSouth Corporation  
 Meeting of the Board of Directors  
 November 13, 2002  
 Minutes

Board: RMS, WTD, LRS, PCW  
 ISC, RPM, JFH, JGG  
 CHM, CSG

Guest: B. Hule, B. Hulse, J. Henry  
 S. Small, Kenny Davis,  
 Dust Denton  
 Mike Nichols - Stephen Grogan

Richard M. Screeby acted as Chairman of the Meeting and Brandon O'Hale acted as Secretary

The Meeting was called to order by Mr. Screeby at 10:05 AM CST

HHEC 293-0226  
 Confidential Treatment  
 Requested by HealthSouth Corp.

The meeting began with an introduction of the Board of Directors with each giving a summary of <sup>his/her</sup> ~~their~~ background and length of ~~for~~ <sup>service</sup> served on the HealthSouth Board

Mr. Dust Denton with Providence Capital who was



motivated, energetic and loyal to HealthSouth and stated that most physicians wanted Mr. Scruby to be the leader through the current crisis and to be more visible in that role.

After Dr. Sarrail's presentation general discussion and questions continued regarding Mr. Datta with additional comments and analysis from Larry Davis. Also discussed with regard to changes or additions to the Board of Directors were cross Board comments in the Corporation's current bank line that would not allow a change of the majority of the HealthSouth Board.

#### CEO Update

Mr. Ocasio provided the Board with an update on the budget process for 2003. He stated that the 1<sup>st</sup> and 2<sup>nd</sup> rate reviews have been received and the 3<sup>rd</sup> and final cut is almost complete. Final 2003 budgets will be presented to the Board within the next 2 to 3 weeks with guidance to the street by mid December.

Mr. Owens stated that 3rd Quarter earnings were not good and we are building from there. Owens advised the Board that the 2003 budget included significant cuts in expenses and the Company would have a press release go out next week advising of a reduction in workforce equal to 1-2% of total employees.

SEC Update

Hobbs

Mr. Davis updated the Board on activities involved with the SEC investigation. A motion was made to continue to use Peter Unger with Fullbright and Tammeter in conjunction with Larry Davis on SEC matters. All other ~~investigations~~ F&J services would cease on all other matters at this time.

written @  
by @

HHEC 293-0229  
Confidential Treatment  
Requested by HealthSouth Corp.

Mrs. Scandhy advised the Board that the Corporation had engaged ~~Stetson Company~~ <sup>Stetson</sup> and Dante W. Amerson as additional advisors.

### Special Litigation Committee Report

Mr. May provided a report on the Special Litigation Committee. He advised that steps have been put in place with the Courts on various derivative actions and the Committee had requested asked the courts for \$5 million to provide their findings. May also advised the Board that a Release Firm had been hired to represent the Company on related Release cases.

### Corporate Governance Committee

Mr. May reported to the Board that a semi-annual draft of the Corporate Governance charter had been completed and was being reviewed. He also requested that Board members respond as soon as possible with comments on the Director Trading Policy.

HHEC 293-0230  
Confidential Treatment  
Requested by HealthSouth Corp.

### Compliance Committee

Dr. Withers reported that the Compliance Committee met prior to the Board.

meets and revised with <sup>Mass</sup> the file  
and Douglas the bottom statistics as  
well as an update ~~to~~ on compliance with  
the Corporate Integrity Agreement. Also  
revised were results from the HCAH  
audit and other Compliance Report instructions

A note was made and agreed to  
accept the Committee minutes <sup>as reported</sup>  
above  
written <sup>①</sup>  
step <sup>②</sup>

HHEC 293-0231  
Confidential Treatment  
Requested by HealthSouth Corp.

### Audit Committee Report

Mr. Stroy presented the Board a report of  
the Audit Committee meeting held prior to the  
Board Meeting. The Committee met with Grant  
and Young to review the audit planning process  
and the scope of the 2002 audit. Mr. Stroy  
advised that the 2002 audit would be more  
complex, involve more time and be more  
expensive. The Committee reviewed recently  
proposed regulations requiring changes to the  
Audit Committee and its charter. They also  
reviewed several post Exam related  
items as they might be relative to



## Corporate Committee Report

Mr. Chudaker provided a report on the Corporate Committee. The Committee approved the Fellowship Fees for Board Committees and Advisors ~~to the~~

Special Litigation Committee  
 Committee Meeting Fees \$2500  
 Committee Telephone Meeting \$1000

## Advisors to Corporate Governance Committee

Retainer \$25,000/yr  
 Meetings \$2,500  
 Telephone Meetings \$1,000

- 1 year engagement cancellable with  
 30 days notice

Mr. Chudaker also advised the Board that the Committee would seek input from outside corporate consultants to assure that the corporate maintained a competitive fee structure on comparison to comparable similar corporations.

pre to approve  Chudaker  
 Wilkins

## Other business

The Board continued discussion on strategy to deal with Mr Denton and purchase Capital. Mr Secomb provided an update on the Anti-Tax legislation and made additional comments on guidance to be provided for 2003 and cost reduction efforts underway.

Mr Secomb and Mr Withers advised the Board that they had met with William Paul, former Corporate Counsel for Phillips Petroleum and former President of the American Bar Association. Mr Paul will be engaged to conduct a review of HealthSouth's legal department as requested by the Board of Directors.

Mr Withers requested reimbursement for legal fees be incurred for outside counsel while serving as Chairperson of the Compliance Committee. The Board approved this request.

**Melendez, Madelene**

---

**From:** Davis, Lanny  
**Sent:** Monday, November 18, 2002 5:56 PM  
**To:** 'dominic.dinapoli@ficonconsulting.com'  
**Subject:** Re: HealthSouth  
**importance:** High

We have forwarded your invoices and excellent narrative to RS. You should call RS directly and set up appointment. I do not think it will work to interpose myself between Fulbright, which hired you, and HealthSouth. The last time I put myself in that position, it was not pleasant, as you know. I will explain to RS as best I can what happened and do my best for you.  
Call me ayc. Hope all is well.

Tab 98

Horton, Bill

---

From: Horton, Bill  
 Sent: Tuesday, December 03, 2002 10:11 PM  
 To: Scrusby, Richard  
 Subject: FW: Privileged and Confidential  
 Tab 99

I think you got the attached e-mail from Lanny this afternoon. I don't think I knew they were working on this. In any event, please let me know whether this strategy is something you want to pursue. I'm happy to look at the drafts, but didn't want to spend time on it unless it was an approach you were interested in.

-----Original Message-----

From: Davis, Lanny [mailto:LDavis@PattonBoggs.com]  
 Sent: Tuesday, December 03, 2002 5:28 PM  
 To: Hansen, Amy; Scrusby, Richard; Horton, Bill  
 Cc: Rasmussen, Garret; Goldberg, Adam; Davis, Lanny  
 Subject: Privileged and Confidential

As previously discussed, I am attaching a draft complaint challenging Transmittal 1753 as a "rule change" not a "clarification" and, thus, a violation of the Administrative Procedure Act. Our APA litigator experts here have read this complaint and have offered me a better than 90% estimate of chances of success of obtaining an injunction. Also, a draft Motion for Summary Judgment.

Eric and I discussed the following strategy: We would send Tom Scully a draft copy on a personal, "off the record basis" (Tom Scully, as you know, was an associate here at Patton Boggs and continued to work closely with us after he left and I know that Eric is very close to Tom -- so it is safe for us to go back-channel this way. We would then call him, invite him to dinner, and talk about a better alternative than litigation (which he must realistically see as an embarrassment to him and the agency). There may be a compromise, for example, that would permit concurrent therapy/individual coding, but fine better when group coding must be used (i.e., depending on the complexity of the procedure and the actual individual supervision by a PT of a particular patient, or other such definitions.)

I suspect his General Counsel will be a hardliner on this, and we still may have to file a suit. If the plaintiff is a physical therapist and/or a patient, we believe there would be standing to sue and that would be best of all. I can't remember the name, but another alternative would be the national physical therapy association based in the minority community. The fact that HealthSouth is funding the case will likely come out, and if it does, we should not fear that, but we should try to get others, including physicians, PTs, etc., to make even a nominal contribution to fund the case along with us.

Reid Smith can and should still be the counsel on the complaint if you decide to file this.

So the first action item: Can Eric and I meet with Scully on the basis outlined in this email.

Bill Horton -- we would appreciate your legal and substantive review of the complaint and the memorandum in support of Summary Judgment. Please call my partner, who did the first drafts of both, and who has considerable APA litigation experience, to offer comments and suggestions. His name is Garret Rasmussen, and his number is 202-457-6343. Adam Goldberg has also assisted, and you can reach him at 202-457-6457.

Best,

Lanny Davis

This e-mail message contains confidential, privileged information intended solely for the addressee. Please do not read, copy, or disseminate it unless you are the addressee. If you have received it in error, please call us (collect) at (202) 457-6000 and ask to speak with the message sender. Also, we would appreciate your forwarding the message back to us and deleting it from your system. Thank you.

This e-mail and all other electronic (including voice) communications from the sender's firm are for informational purposes

This communication is intended by the sender to constitute either an electronic record or an electronic signature, and no reliance should be placed on any agreement by the sender to conduct a transaction by electronic means. Any such intention or agreement is hereby expressly disclaimed unless otherwise specifically indicated.

For more information about our firm, please visit our website at <http://www.patonboggs.com>.

**Melendez, Madelene**

**From:** Davis, Lanny  
**Sent:** Monday, January 27, 2003 7:47 AM  
**To:** 'jason.hervey@healthsouth.com'; 'rscrushy@healthsouth.com'; 'rpmay@aol.com';  
'mhansen@khntc.com'; 'bill.horton@healthsouth.com';  
**Cc:** 'jmr@hsy.com'; 'litigation@msn.com'; Goldberg, Adam  
**Subject:** NY Times Sat story

FYI. The comment below from Hollis, tho I know you have negative memories of her, is typical. I have heard from a dozen or so reporters and corporate governance reform attorneys over weekend expressing very positive comments about Sat's Times story.

The original story Reed was writing was about denavue case decision planted by Plaintiffs lawyers. Thus, I hope you understand why at 7 pm on Friday night, with deadline 30 minutes away, I had to make a decision to try to re-focus her story on the positive and knock down the negative. I apologize for not being able to pre-clear that judgment with each of you, but up to now you have trusted my ability--under extraordinary circumstances such as these--to make such an emergency judgment and to take responsibility if things don't turn out right. In this case, the story was a very positive one for HealthSouth and especially for Richard as honoring his commitment to corporate governance reform and my comment blowing off significance of denavue case reversed what would have been very negative story.

I have heard background criticism of my role regarding the press release clearing RS re impact on denavue case. Some revisionist history by some people needs correction. Please recall that we deliberately, collectively -- including all Board members unanimously --made a decision to get the Richard Scrushy "cleared" story out, even if it prejudiced our position on the stay motion in the Denavue case, since all judged clearing RS' name as more important than that case. Clearly, in retrospect, that was the right decision and priornes by RS and the entire Board.

Moreover, it is clear from the decision that the main reason for the outcome was not Bob May's quote but the INSISTENCE by Hal Hirsch to be company counsel, rather than independent counsel to the SLC. That decision was made in my absence and against my recommendation -- I still don't know how or why -- tho I know it was not Mike Rediker's recommendation either.

Best,  
Lanny

Tab 100

-----  
Sent from my BlackBerry Wireless Handheld

-----Original Message-----

**From:** Rafkin-Sax, Hollis <Hollis.Rafkin-Sax@edelman.com>  
**To:** 'ldavis@pattonboggs.com' <LDavis@PattonBoggs.com>  
**Sent:** Sat Jan 25 11:30:38 2003  
**Subject:** Congratulations

The governance advisors to the board are first class and clearly demonstrates your fine art of negotiation. Quite an impressive standard you have set.

Hollis

**Melendez, Madelene**

---

**From:** Davis, Lanny  
**Sent:** Monday, February 10, 2003 7:30 PM  
**To:** 'rpmay@aol.com'; 'bobmay9788@msn.com'  
**Subject:** Fw: Sad

Why am I not surprised! And why do I grow more outraged by the minute? Pass on the news to my friend Jon Hansen.

-----  
Sent from my BlackBerry Wireless Handheld

Tab 101

-----Original Message-----

**From:** Davis, Lanny <LDavis@PattonBoggs.com>  
**To:** 'rscrushy@healthsouth.com' <rscrushy@healthsouth.com>  
**CC:** 'ehanson@usstrategies.com' <ehanson@usstrategies.com>; 'jason.hervey@healthsouth.com' <jason.hervey@healthsouth.com>  
**Sent:** Mon Feb 10 12:57:09 2003  
**Subject:** Sad

I would have hoped after everything, not the least of which was my public defense of you in which I believed and still do, that you would have called me on the phone personally, rather than allow a legalistic, cold termination letter from Bill Horton "terminating" me, which I found to be insulting. It breaks my heart, actually, because I would have expected you to be sensitive at least as a friend on a better way to do this.

In any event, my best wishes to you. I repeat my offer to give you advice as a friend--2henever you wish and off the clock.  
Lanny

-----  
Sent from my BlackBerry Wireless Handheld

**Goldberg, Adam**

---

**From:** Davis, Lanny  
**Sent:** Monday, March 24, 2003 10:17 PM  
**To:** Goldberg, Adam  
**Subject:** Fw: draft memo re conflict issue



Tab 102

LDavis conflict  
memo(version1... Please complete.

-----  
Sent from my BlackBerry Wireless Handheld

-----Original Message-----  
From: Stone, Scott <SStone@PattonBoggs.com>  
To: Davis, Lanny <LDavis@PattonBoggs.com>  
Cc: Goldberg, Adam <AGoldberg@PattonBoggs.com>  
Sent: Mon Mar 24 17:03:37 2003  
Subject: draft memo re conflict issue

Lanny and Adam, attached is a draft memo. Since the conclusion depends on the facts of what consultations we may have with Scrusby individually, Adam will need to vet and edit/expand the statements on that in the memo.

I still would like to add a couple of cases to give the memo a bit more weight. I'll do that by 9 am tomorrow, so Adam, if you could turn around any revisions you have by then, we can give Lanny a presentable memo by 10 am tomorrow.



2550 M Street NW  
Washington DC 20037  
(202) 457-6000

Facsimile (202) 457-6315

## MEMORANDUM

DRAFT 3/24/03

---

**To:** Lanny J. Davis  
**From:** Scott N. Stone  
**Date:** March 24, 2003  
**Subject:** Representation of HealthSouth and Its Acting CEO

---

### Question

You have asked whether, in light of our ongoing representation of HealthSouth Corporation, and our arguable prior representation of HealthSouth's former Chairman and CEO, Richard M. Scruschy, we would be precluded from continuing to represent HealthSouth and its acting CEO, Robert May, including as to matters currently under investigation by the Securities and Exchange Commission and matters at issue in pending class action securities litigation.

### Short Answer

There does not appear to be any reason why we could not represent both HealthSouth and Mr. May in connection with the ongoing SEC investigation and other matters, with the possible exception of matters relating to the issue of the impact on HealthSouth of certain Medicare rule changes.

### Background

Patton Boggs has represented HealthSouth as counsel of record in a class action securities lawsuit alleging that HealthSouth failed to disclose the financial effects that would likely result

**PB 02933**



from new federal rules reclassifying certain categories of Medicare and Medicaid reimbursements. Patton Boggs' representation of HealthSouth is pursuant to an engagement letter dated \_\_\_\_\_, in which Patton Boggs was engaged to represent Mr. Scrushy, HealthSouth, "and/or" senior management of HealthSouth. Notwithstanding the engagement letter, Patton Boggs' representation has arguably been limited to the representation of HealthSouth itself. Patton Boggs engaged in very limited, if any, discussions with Mr. Scrushy regarding matters that could bear upon his own individual liability or culpability for securities or other violations of law. Indeed, the only such conversation Patton Boggs ever had with Mr. Scrushy consisted of Patton Boggs' asking Mr. Scrushy what, if any, awareness Mr. Scrushy had of the financial impact of the federal reimbursement rule changes, and Mr. Scrushy's denial of any such awareness. This conversation was well within the scope of Patton Boggs' representation of HealthSouth. Patton Boggs at no time advised Mr. Scrushy concerning his individual liability or culpability; rather, Patton Boggs used the information provided by Mr. Scrushy only in the representation of HealthSouth itself. Hence, the best view of the facts is that Patton Boggs never actually represented Mr. Scrushy in his individual capacity, or that if Patton Boggs did represent Mr. Scrushy, it provided no legal services to him in his individual capacity, and had no confidential attorney-client conversations with him in his individual capacity.

In February 2003, at the instruction of Mr. Scrushy, Mr. Horton, HealthSouth's [former?] General Counsel, requested that Patton Boggs withdraw as counsel for HealthSouth in the class action suit. Pending further conversations with HealthSouth, Patton Boggs declined to do so, and still has not done so. In the meantime, Mr. Scrushy has resigned, and Mr. May has become Acting CEO of HealthSouth. Mr. May has asked Patton Boggs whether there would be any impediment under professional conflict of interest rules to Patton Boggs' continuing to represent HealthSouth, including on pending SEC and federal investigations that might include within their scope inquiry into the financial impact of the federal reimbursement rule changes.

Mr. Scrushy has not spoken with Patton Boggs concerning his individual legal situation, and has retained separate counsel to deal with the ongoing federal investigative matters

**PATTON BOGGS LLP**  
ATTORNEYS AT LAW

Discussion

The representation of HealthSouth in the pending investigations could as a practical matter be adverse to Mr. Scrushy, in that HealthSouth might provide to federal authorities documents and information that could implicate Mr. Scrushy in wrongdoing. In addition, HealthSouth might seek advice on avenues of legal recourse against Mr. Scrushy. Patton Boggs would under applicable ethics rules be disqualified from representing HealthSouth if Patton Boggs had represented Mr. Scrushy on matters that were the same as or substantially related to matters as to which Patton Boggs represented Mr. Scrushy.

As set out above, Patton Boggs appears not to have had any actual attorney-client relationship with Mr. Scrushy. Although there is some evidence of an attorney-client relationship, notably the engagement letter of \_\_\_\_\_ [date], that evidence could be rebutted by a showing that Patton Boggs did not advise Mr. Scrushy individually about his own personal liability or culpability, and did not receive any confidential information from Mr. Scrushy about matters that might be within the scope of the ongoing federal investigations. [case cites]

## Fulbright &amp; Jaworski L.L.P.

A Registered Limited Liability Partnership  
 666 Fifth Avenue, 31st Floor  
 New York, New York 10103-3198  
 www.fulbright.com

## MEMORANDUM

TO: David Barrack Tab 103  
 CC: Hal Hirsch  
 FROM: Glen Banks  
 DATE: September 23, 2002  
 RE: HealthSouth

---

I reviewed the class action complaints and derivative complaint in the binder delivered to me on Friday. The one derivative complaint alleges a host of self-dealing transactions involving Richard Scrushy, HealthSouth's Chairman of the Board and CEO at the time of the transactions. The self-dealing transactions in the derivative complaint are summarized in point A. below.

The 13 securities law class actions all allege fraud in violation of § 10(b) and Rule 10b-5 of the '34 Act and § 20(a) of that statute, the control person provision.

The allegations of the securities fraud complaints are similar. In December 2001, HealthSouth gave guidance of \$1.14 eps for 2002 and subsequently repeatedly confirmed that guidance, doing nothing to correct or update it through August 26, 2002. That guidance was disseminated with knowledge that Medicare, the source of nearly one-third of HealthSouth's revenues, would be setting new regulations in a Prospective Payment System ("PPS") which HealthSouth allegedly knew would reduce reimbursement to it.

The key reimbursement issue addressed in the complaints, concurrent therapy, can be explained as follows. Assume in a one hour physical therapy session, a therapist treats two Medicare patients, for example, one who had a right knee replacement and another who had a left knee replacement. During the session, the therapist directs and supervises both patients and, at various times, works individually with each patient.

Prior to the PPS becoming effective, HealthSouth would bill Medicare for one hour of "individual therapy" for each patient. The complaints insinuate that Medicare believed such therapy should have been billed as "group therapy" which would have been reimbursed at a substantially lower rate.

The complaints allege that a focus of the PPS was to definitively define what constituted individual therapy so that HealthSouth and others would no longer get paid for concurrent therapy at individual therapy rates but would be paid at the lower group therapy rate.

The crux of the complaints is that despite knowing that the PPS would lower Medicare payments for concurrent therapy and thereby impact its revenues and earnings, from December 14, 2001 through August 26, 2002, HealthSouth repeatedly falsely told the investing public that

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David Barrack  
 September 23, 2002  
 Page 2

(i) the company would benefit from the PPS and (ii) the company was comfortable with the \$1.14 eps guidance for 2002 that it had disseminated in December 2001. While HealthSouth was making these allegedly false statements, Scrushy disposed of 75% of his interest in the company selling 5,275,360 shares on May 17 at \$14.05 for proceeds of in excess of \$74 million and, on July 31, delivering 2,506,770 shares to HealthSouth valued at \$10.06 per share in repayment of a loan from the company.

Named as defendants in the securities law complaints are HealthSouth, Scrushy, Western Smith, the company's CFO and Executive Vice President, William Owens, the company's Chief Operating Officer, and George Strong, a director of the company who sold stock in the class period for proceeds of approximately \$2.8 million.

Point A below summarizes the allegations in the Derivative Claim. Point B below sets forth a timeline of the allegations in the securities fraud claims

A. **The Allegations in the Derivative Claim**

- The compensation paid to Scrushy was "grossly excessive."
- Scrushy caused HealthSouth to purchase equipment and services from GG Enterprises, a company he controlled, at prices greater than what could have been paid to an independent vendor.
- Scrushy caused HealthSouth to loan \$10m. to 21<sup>st</sup> Century Health Venture L.L.C. which went out of business causing a loss on the loan. Money that went to 21<sup>st</sup> Century was part of a scheme to improperly divert company funds to Scrushy.
- Scrushy has an interest in Capstone Capital Corporation. HealthSouth sold certain depreciable buildings to Capstone and then leased back the property at inflated rental amounts as part of a plan to divert HealthSouth funds to Scrushy. A Qui tam proceeding arising from this sale/leaseback resulted in a \$7.9 million settlement.
- HealthSouth improperly made substantial loans to officers and directors at below market interest rates.
- HealthSouth invested \$2 million in Med.Center.Direct.com, Inc. a company in which Scrushy and other insiders had a substantial interest. HealthSouth also entered into 10 year agreement under which Med.Center would be the company's exclusive e-procurement vendor of medical product and supplies. Med.Center was a HealthSouth corporate opportunity and should not have been independently pursued by HealthSouth executives.
- HealthSouth established Source Medical Solutions, Inc. and let the insiders buy-in at sweetheart deal prices.

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- HealthSouth advanced \$82m. to Source.
- HealthSouth did a sweetheart sale-leaseback transaction with Source for HealthSouth intellectual property on terms favorable to Source.
- In July 2002, HealthSouth accepted 2,506,770 shares from Scrusby, valued at \$10.06 per share, in repayment of a loan. The valuation was excessive and unreasonable given what Scrusby knew about the Medicare/Medicaid problem which would have an estimated impact of reducing HealthSouth's earnings by \$175 million.
- Claims
  - Breach of Fiduciary Duty
  - Waste
  - Misappropriation of Corporate Assets
  - Unjust Enrichment
  - Breach of Contract
  - Willful Violation of Law
  - Civil Conspiracy

**B. The Timeline for the Securities Fraud Claims**

12/14/2001	<ul style="list-style-type: none"> <li>• HealthSouth press release projected EPS of \$1.14 in 2002.</li> <li>• Scrusby said: "we believe that the new rules [the Prospective Project System ("PPS") being implemented by Medicare as of January 1] will enhance our 2002 results of operations as they are phased in across our inpatient rehabilitation facilities next year."</li> </ul>
1/14/2002	<ul style="list-style-type: none"> <li>• HealthSouth press release stated that the company is comfortable with an estimate of \$1.14 EPS for 2002.</li> <li>• The release stated that HealthSouth expected a positive impact from the implementation of the new PPS.</li> <li>• Scrusby said: "We have been preparing for the implementation of PPS for several years. . . this new system is not a surprise, and our intensive</li> </ul>

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Page 4

	cost management efforts have prepared us well for it."
1/22	<ul style="list-style-type: none"> <li>HealthSouth press release stated that the Company had received notification of its first PPS payments.</li> <li>According to the press release, the payments were "identical to the expected payment predicted by HealthSouth's internal PPS payment model."</li> <li>Scrusy said the notifications validated the accuracy of HealthSouth's internal claims model and that he expected "future payments will continue to support the positive PPS impact to earnings that we have previously predicted."</li> <li>Scrusy reaffirmed the earnings guidance of \$1.14 EPS.</li> </ul>
2/14	<ul style="list-style-type: none"> <li>HealthSouth director George Strong sold 73,885 shares for proceeds of \$895,121</li> </ul>
3/12	<ul style="list-style-type: none"> <li>HealthSouth press release announced fourth quarter results. Scrusy said: "our early experience under the new inpatient rehabilitation prospective payment system is confirming our expectations for the positive impact that PPS will have on our business."</li> </ul>
3/27	<ul style="list-style-type: none"> <li>HealthSouth filed its Form 10-K which stated: "freestanding inpatient rehabilitation facilities and hospital based rehabilitation units are being placed under a PPS to be phased in beginning January 1, 2002." The PPS regulations were implemented pursuant to the Balanced Budget Act of 1997.</li> <li>The 10-K stated: "we believe that our low-cost profile favorably positions us to respond to reimbursement pricing pressure."</li> </ul>
5/2	<ul style="list-style-type: none"> <li>HealthSouth press release announced first quarter earnings consistent with consensus estimates.</li> <li>Scrusy said: "Our first wave of inpatient rehabilitation facilities moved into the new inpatient rehabilitation prospective payment system beginning January 1, and just as we had projected, PPS had a positive impact on our bottom line. We have spent years preparing for this change. Lowering our costs and increasing our efficiencies, and our initial PPS payments have continued to come in on target with our preliminary estimates."</li> </ul>
5/10	<ul style="list-style-type: none"> <li>HealthSouth filed its Form 10-Q for the first quarter.</li> </ul>

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5/14	<ul style="list-style-type: none"> <li>• Scrusby sold 5,275,360 shares at \$14.05 per share for proceeds in excess of \$74 million. This was his first sale of HealthSouth stock since 1997.</li> </ul>
5/17	<ul style="list-style-type: none"> <li>• As alleged in ¶ 28 of the <u>Strauss</u> Complaint:                       “In addition to the existing policies for group therapy reimbursement that had been in place for years, defendants were most recently notified of CMS’ [Center for Medicare and Medicaid Services] Program Transmittal clarifying certain reimbursement policies for outpatient rehabilitation services when one of the lawyers for HealthSouth came across the CMS Transmittal on May 17, 2002. The Transmittal (effective as of July 1, 2002) reiterated that outpatient therapy services provided to two or more patients in a single time period (concurrent therapy) be billed as group therapy services, rather than as an individual therapy code that generates a higher reimbursement per treatment than the group therapy code. As an analyst in the industry explained, Medicare reimbursement for group therapy services is approximately \$14 per patient per day whereas reimbursement for individual therapy service is \$21 per patient for each 15-minute increment of therapy. Thus, under the CMS directive, Medicare reimbursement for a patient receiving one hour of concurrent therapy could potentially be reduced from \$84 to \$14.”</li> <li>• The complaints insinuate that the referenced CMS Transmittal was merely a reiteration of the government’s prior position that concurrent therapy should be billed and reimbursed as “group therapy,” not “individual therapy.”</li> <li>• According to paragraph 27 of the <u>Strauss</u> complaint, the required billing practice for concurrent therapy was set forth in a proposed rule of the Department of Health and Human Resources dated May 10, 2001. 42 C.F.R. §410, 411, 413, 424, 482, 489 (2000).</li> <li>• Since the mid-1990s, according to CMS policy, group therapy included services provided simultaneously to two or more individuals by practitioners. The individuals can be, but need not be, performing the same activity. Although the therapist must provide constant attendance, one-on-one patient contact is not required. Thus, “[i]f the provider is overseeing the therapy of more than one patient during a period of time, he or she must bill the code for group therapy...since he or she is not furnishing constant attendance to a single patient.” 42 C.F.R. §410, 414 (1994). The same policy and identical language was reiterated in the 1996 rules and regulations. 42 C.F.R. §410, 415 (1996).</li> </ul>

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	<p>*** Although the securities fraud complaints are focused on the events in 2002, consideration should be given to the possibility of the following assertion that could lead to far broader problems: Since the mid 1990s, despite applicable Medicare regulations requiring concurrent therapy to be billed as group therapy, HealthSouth improperly billed concurrent therapy as individual therapy.</p>
6/7	<ul style="list-style-type: none"> <li>Strong sold 66,665 shares for proceeds of \$933,310.</li> </ul>
6/11	<ul style="list-style-type: none"> <li>Strong sold 67,216 shares for proceeds of \$941,024.</li> </ul>
7/11	<ul style="list-style-type: none"> <li>HealthSouth press release said it was comfortable with its EPS estimate. It said: "the fundamentals of our business continue to be solid, and we remain confident in our guidance for the rest of the year."</li> </ul>
7/29	<ul style="list-style-type: none"> <li>Barron's published an article prepared with HealthSouth input which said the PPS will have a positive impact on HealthSouth because, since its costs tend to be lower, the PPS will allow HealthSouth, for the first time, to make a profit on some portion of the 31% of its business that comes from Medicare.</li> </ul>
7/31	<ul style="list-style-type: none"> <li>To repay a loan owed to the company, Scrushy transferred 2,506,770 shares to the Company. Given the price of HealthSouth stock at the time (\$10.06), the transferred shares had a value of \$25,218,106.</li> <li>As a result of the May sale and the July transfer, Scrushy disposed of 75% of his interest in HealthSouth.</li> </ul>
8/7	<ul style="list-style-type: none"> <li>HealthSouth press release reported 2Q results that showed increased revenues and earnings. Scrushy said: "This clearly demonstrates the success we are having under the new Prospective Payment System."</li> </ul>
8/8	<ul style="list-style-type: none"> <li>A management sponsored conference call gave no hint of PPS adversely impacting HealthSouth's revenues or earnings.</li> </ul>
8/12	<ul style="list-style-type: none"> <li>Follow-up article in Barron's described HealthSouth as a health-care business at a "bargain price."</li> </ul>
8/14	<ul style="list-style-type: none"> <li>HealthSouth filed its Form 10-Q for the second quarter.</li> <li>Although the 10-Q represented that HealthSouth could not predict the impact of any proposals regarding Medicare reimbursement limits, it was totally silent on the effect of the PPS upon the Company.</li> <li>HealthSouth filed Form 8-K to comply with SEC Order 4-460.</li> </ul>

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 By Dechert LLP on behalf of its client

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 September 23, 2002  
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	Scrushy and the CFO certified the company's results.
8/26	<ul style="list-style-type: none"> <li>HealthSouth prospectus in a \$998 million note exchange became effective. The Registration Statement on Form S-4/A generally talked about the risk of a change in Medicare reimbursement policy. There was no discussion of any adverse impact upon the company by the PPS.</li> </ul>
8/27	<ul style="list-style-type: none"> <li>HealthSouth press release said impact of reimbursement change "will require material revisions" to the company's business model and that EBITA will be \$175 million less than previously projected.</li> <li>Press release said that effective July 1, CMS had issued a directive requiring out-patient therapy provided to two or more patients at a single time to be billed a "group therapy" which would significantly lower reimbursement for services that had been billed as individual therapy. HealthSouth believed there was "substantial confusion" concerning what this directive meant and, in July and August, HealthSouth "sought clarification" through meetings with its intermediary and CMS officials. HealthSouth contended that "pending further clarification," it was implementing a "conservative interpretation of current Medicare coding requirements."</li> <li>The press release stated: "the directive implemented on July 1 is inconsistent with many providers' understanding of appropriate coding practices."</li> </ul>
8/27-28	<ul style="list-style-type: none"> <li>News media reported CMS directive was no surprise to industry insiders who knew about it for months.</li> <li>Analysts downgraded HealthSouth and question management's credibility.</li> <li>Rating agencies put HealthSouth on CreditWatch.</li> <li>CMS Administrator was quoted in Reuters that he is "astounded" by the claims in HealthSouth's press release.</li> <li>A Prudential report expressed "surprise" at HealthSouth's announcement and the timing of HealthSouth's reaction to the CMS revisions because such revisions are the result of a long process so that companies have ample time not only to challenge proposed changes but to effect necessary operational changes.</li> </ul>

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 By Dechert LLP on behalf of its client

FJ 000516

**FULBRIGHT & JAWORSKI L.L.P.**

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 FACSIMILE: (212) 318-3400

**CONFIDENTIAL ATTORNEY WORK PRODUCT  
 FOR BOARD OF DIRECTORS EYES ONLY**

Tab 104

October 1, 2002

The Board of Directors of HealthSouth Corp.  
 One HealthSouth Parkway  
 Birmingham, Alabama 35243

**HHEC 293-0300**  
 Confidential Treatment  
 Requested by HealthSouth Corp.

Ladies and Gentlemen:

As you are aware, HealthSouth Corp. ("HealthSouth" or the "Company") and its Board of Directors have engaged Fulbright & Jaworski L.L.P. to represent them in an investigation by the Securities and Exchange Commission and to conduct a review of the Company's disclosures and related events. Among other things, we have been asked to assess, to the extent ascertainable, whether (i) at the time of the exercise of options and sale of HealthSouth Common Stock by Richard M. Scrushy on or about May 14, 2002 (the "Option Exercise and Sale") or (ii) at the time of transfer of HealthSouth Common Stock to the Company by Mr. Scrushy in satisfaction of the principal amount of loans from HealthSouth on or about July 31, 2002 (the "Loan Repayment"), he was aware of the potential effect on the Company of Transmittal 1753 of the MEDICARE CARRIERS MANUAL or the policy expressed therein ("Transmittal 1753").

We understand that the Board of Directors has formed a special investigatory committee (the "Special Committee") to review a variety of allegations made against the Company in a shareholder derivative litigation, including allegations relating to the Loan Repayment. The Special Committee has retained its own independent counsel to assist the Special Committee in its review of these allegations. The independent members of the Board of Directors should look to the Special Committee and its independent counsel for their report on these and other matters.

Our review only began on September 24, 2002. We have begun to review documents and other materials produced by certain officers and employees of HealthSouth in response to a memorandum prepared at our request by the Company's General Counsel, William W. Horton, and the minutes of the Board of Directors and the committees of the Board of Directors. We have not yet received responses from all of the officers and employees to whom the memorandum was addressed or copies of minutes of all meetings of the Board of Directors or certain of its committees. In addition, we have reviewed and are continuing to review electronic data produced by HealthSouth consisting of the e-mail and application files of seventeen key

The Board of Directors of HealthSouth Corp.  
October 1, 2002  
Page 2

**CONFIDENTIAL**  
**ATTORNEY WORK PRODUCT**

officers and directors.

Our review is far from complete, and we are awaiting additional data from certain officers and employees. In addition, we have conducted interviews with Richard M. Scrushy, William T. Owens, William W. Horton, Jeanie Davis, Frederick Schmitt, Jr. and Susan Jones Smith. We expect to conduct additional interviews with some or all of these individuals and to interview additional officers and employees before completing our investigation.

The Board of Directors has requested an update for its meeting on October 1, 2002, of the status of our investigation of the Option Exercise and Sale and the Loan Repayment. In the course of our preliminary work, we have not found any factual data that establish that Richard M. Scrushy was aware at the time of the Option Exercise and Sale or at the time of the Loan Repayment of the potential effect on the Company of Transmittal 1753. In the course of our preliminary work, we have determined that certain members of senior management other than Mr. Scrushy had varying levels of knowledge concerning Transmittal 1753 commencing no later than June 2002; however, we have not ascertained at this time that they disclosed such knowledge to Mr. Scrushy prior to early August.

We have not completed our investigation, and facts and circumstances that come to our attention during the course of our engagement may lead to a conclusion different than that suggested by the limited amount of materials we have reviewed to date. Accordingly, the Board of Directors should not view this letter as a conclusion with respect to any of the matters discussed herein or the potential outcome of any regulatory investigation or legal action. In addition, please note that this letter is not a comment on any other matter we have investigated or may be asked to investigate in the future.

This letter has been prepared solely for the purpose of updating the Board of Directors on the status of our investigation. The existence and contents of this letter are confidential and privileged information intended for the private use of the Board of Directors, and may not be used for any other purpose or quoted or disclosed to any third party, or referred to in any manner, without our express written consent. This letter may not be furnished to any other persons or entities without our prior written consent.

Very truly yours,



**HHEC 293-0301**  
Confidential Treatment  
Requested by HealthSouth Corp.

**FULBRIGHT & JAWORSKI L.L.P.**

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Tab 105

October 21, 2002

**Privileged and Confidential:  
 Attorney Work Product Doctrine Applies**

**BY HAND DELIVERY**

The Board of Directors of HealthSouth Corporation  
 One HealthSouth Parkway  
 Birmingham, Alabama 35243

HHEC16/0111

Ladies and Gentlemen:

On September 18, 2002, HealthSouth Corporation ("HealthSouth" or the "Company") and its Board of Directors engaged Fulbright & Jaworski L.L.P. (or "F&J") to represent them in an investigation by the Securities and Exchange Commission (the "SEC") and to conduct a review of the Company's disclosures and related events (the "Review"). In the process of that Review, you have also asked F&J to assess, to the extent ascertainable, whether (i) at the time of the exercise of options and sale of HealthSouth common stock by Richard M. Scrushy on or about May 14, 2002 (the "Option Exercise and Sale") or (ii) at the time of transfer of HealthSouth Common Stock to the Company by Mr. Scrushy in satisfaction of the principal amount of a loan from HealthSouth on or about July 31, 2002 (the "Loan Repayment"), Mr. Scrushy was aware of the potential financial effect on the Company of Transmittal 1753 of the Centers for Medicare and Medicaid Services ("CMS") to the Medicare Carriers Manual, specifically the language "added to clarify payment policy for group therapy services" ("Transmittal 1753"). This letter supplements F&J's letter dated October 1, 2002.

Fulbright & Jaworski L.L.P. understands that the Board of Directors has formed a special investigation committee (the "Special Committee") to review a variety of allegations made against the Company in a shareholder derivative action suit, including allegations relating to the Loan Repayment. The Special Committee has retained its own independent counsel to assist the Special Committee in its review of these allegations. The individual members of the Board of Directors should look to the Special Committee and its independent counsel for their report on these and other matters.

Fulbright & Jaworski L.L.P. is in the process of a broad inquiry concerning Transmittal 1753, the Company's response to and operations in consideration of Transmittal 1753, and the Option Exercise and Sale and the Loan Repayment by Mr. Scrushy. The Review of Transmittal 1753 and the Company's response to and operations in consideration of Transmittal 1753 are ongoing and will likely not be completed for some time. While Fulbright & Jaworski L.L.P.'s Review concerning Transmittal 1753 is not yet complete, this letter sets forth F&J's findings

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Confidential Treatment  
 Requested by HealthSouth  
 Corp.  
 Ureg.

The Board of Directors of HealthSouth Corporation  
 October 21, 2002  
 Page 2

regarding the facts and circumstances surrounding the Option Exercise and Sale and the Loan Repayment by Mr. Scrusby.

A summary of Fulbright & Jaworski L.L.P.'s Review, chronology of relevant events, interviews conducted, and specific factual findings are set forth below. At your request, F&J continues its Review of certain matters relating to Transmittal 1753. Should F&J discover any facts or circumstances that are material to the matters expressed in this letter with respect to Mr. Scrusby, F&J will supplement its findings.

#### I. REVIEW PROCESS

HealthSouth maintains certain practices in regard to the regular and routine destruction of non-electronic data and electronic data. On September 19, 2002, Fulbright & Jaworski L.L.P. requested orally and in writing that the Company act immediately to preserve documents. On September 20, 2002, William Horton, Executive Vice President and General Counsel, directed all HealthSouth personnel to "IMMEDIATELY take all steps necessary to ensure that all documents, electronic files and e-mails under your control are preserved until [the Company] can ensure that all relevant documents have been appropriately gathered and reviewed." Fulbright & Jaworski L.L.P. discovered destroyed documents: on September 26, 2002 in a file room where F&J has been advised that certain HealthSouth executives other than Mr. Scrusby maintained files; and on October 2, 2002 in a copy room in the north wing of the third floor of HealthSouth's corporate offices. Fulbright & Jaworski L.L.P.'s Review is necessarily predicated in part upon the preservation and production of documents by HealthSouth, and that none of the destroyed documents were relevant to the Review.

##### A. Non-electronic Data Collection

Between September 24, 2002 and October 3, 2002, Fulbright & Jaworski L.L.P. requested and obtained numerous documents and materials from Mr. Horton. The requested documents and materials included but were not limited to documents requested by the SEC in its September 17, 2002 letter (the "SEC Request"). The documents produced by Mr. Horton were reviewed both for relevance to F&J's Review and for responsiveness to the SEC Request.

On September 24, 2002, Fulbright & Jaworski L.L.P. prepared a memorandum that directed its recipients to search their files and produce all documents that were, as outlined in the memorandum, relevant to F&J's Review and responsive to the SEC Request. On September 25, 2002, Mr. Horton distributed the memorandum to 39 Company employees, as well as to members of the Board of Directors. The Company employees who received the search memorandum, who were selected by F&J in consultation with Mr. Horton, were:

1. Brooks Adams Assistant to the Chairman	3. Jason Brown Vice President of Finance
2. Cristy Blalock Vice President, Budgets	4. Jean Davis Vice President, Inpatient Operations

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5. Richard S. Davis Group Vice President, Finance and Assistant Treasurer	16. Jason Hervey Chief Marketing and Communications Officer
6. Judy B. Dean Group Vice President, Payor Relations	17. Pam Hodges Administrative Assistant to Mr. Owens
7. William Daniel Douglas, Jr. Vice President, Information Technology	18. William W. ("Bill") Horton Executive Vice President and Corporate Counsel
8. April Edwards Case Manager	19. M. Sean Huffman Senior Vice President, Ambulatory Services
9. Mary Esclavon Administrative Assistant to the Chairman	20. Kenneth K. Livesay Senior Vice President and Chief Information Officer
10. Lynn Fleming Regional Vice President Inpatient Operations	21. Malcolm E. ("Tadd") McVay Executive Vice President and Treasurer
11. Patrick A. Foster President and Chief Operating Officer, Inpatient Operations	22. John Monteith Regional Vice President
12. Beall D. ("Nap") Gary, Jr. Senior Vice President and Assistant Corporate Counsel	23. Jessica Nantz Senior Vice President, Ambulatory Services
13. Marconia C. Goff Senior Vice President, Ambulatory Services	24. Aimee Nichols Administrative Assistant to the Chairman
14. Brandon O. ("Brad") Hale Executive Vice President, Administration and Corporate Secretary	25. William T. ("Bill") Owens Chief Executive Officer; former President and Chief Operating Officer, former Executive Vice President and Chief Financial Officer, and former Senior Vice President of Finance and Controller
15. Emery Harris Group Vice President and Assistant Controller	26. Sam A. Pilliteri, Jr. Vice President, Finance and Reimbursement

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27. Christopher J. Reading Group Vice President, Ambulatory Services	34. Richard Stec Vice President, Payor Contracting and Support
28. Daniel J. Riviere Senior Vice President, Ambulatory Services	35. Larry D. Taylor President and Chief Operating Officer, Ambulatory Services
29. Frederick L. ("Rick") Schmitt, Jr. Vice President Business Offices, Ambulatory Services	36. Robert C. Tillman Regional Vice President Clinical Department, Ambulatory Services
30. Gerald P. Scrusby Senior Vice President, Physical Resources	37. Gail Watson Administrative Assistant to Mr. Horton
31. Richard M. Scrusby Chairman of the Board and former Chief Executive Officer	38. Casey Worrell Former Assistant to the Chairman
32. Susan Jones-Smith Senior Vice President, Finance and Reimbursement	39. Matthew Zurek, PT Regional Vice President, Clinical Coordinator
33. Weston L. Smith Executive Vice President and Chief Financial Officer	

In addition to Richard M. Scrusby and William T. Owens, the members of the Board of Directors who received the search memorandum were:

1. John S. ("Jack") Chamberlin	5. Charles W. Newhall III
2. C. Sage Givens	6. Larry Striplin, Jr.
3. Joel C. Gordon	7. Phillip C. Watkins, M.D.
4. Robert May (prospective member)	

By September 30, 2002, all persons who had received the search memorandum had responded either with what they indicated were all of the responsive documents in their possession or a notification that they had no such documents. The total documents produced by all persons comprised approximately four bankers' boxes. These documents were reviewed both for relevance to F&J's Review and for responsiveness to the SEC Request.

On September 30, 2002, Fulbright & Jaworski L.L.P. drafted a second search memorandum that requested all documents relating to any trade or transfer of Company stock by any Company executive, officer or member of the Board of Directors during the period April 1, 2002 to August 31, 2002. Mr. Horton distributed this search memorandum to the following persons, who were selected by F&J in consultation with Mr. Horton:

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1. Jason Brown	6. William T. ("Bill") Owens
2. Jean Davis	7. Richard M. Scrushy
3. Richard S. Davis	8. Susan Jones-Smith
4. Brandon O. ("Brad") Hale	9. Weston L. Smith
5. Malcolm E. ("Tadd") McVay	

By the close of business on October 1, 2002, all persons who had received the search memorandum had responded.

#### B. Electronic Data Collection

On September 26, 2002, in an effort to devise an accurate and efficient strategy for data collection and review, members of Fulbright & Jaworski L.L.P.'s Information Systems staff obtained information from HealthSouth's Information Technology Department regarding the Company's protocol for managing and storing electronic business records, including email and attachments, word processing documents, spreadsheets, and other types of electronic data. Beginning on September 28, 2002, the Company's Information Technology Department, under the direction and supervision of F&J, began electronically collecting and producing data, on a "rolling delivery basis." The data delivery was completed on October 14, 2002. During that period, approximately 59,000 documents (approximately 546,300 pages) were collected from HealthSouth computer records relating to 19 HealthSouth employees and loaded to a discovery management system for review by Fulbright & Jaworski L.L.P. These documents were not reviewed but filtered for relevance using electronic search terms and methods selected by F&J. Such "sorting" produced a total of approximately 12,300 documents (approximately 119,600 pages) that F&J deemed more likely to be pertinent to its Review. A team of approximately ten F&J lawyers has reviewed these documents both for relevance to F&J's Review and for responsiveness to the SEC Request. Fulbright & Jaworski L.L.P. has not examined electronically-produced documents that were not responsive to the search terms.

All electronic documents were retrieved from one of three primary sources: (i) the Company's file server, which houses "sub-directories" for each employee; (ii) the hard drives of individual desktop computers, using HealthSouth's computer network to capture information remotely; and (iii) emails stored directly on HealthSouth's computer network. Preexisting HealthSouth document retention policy has been that undeleted emails are maintained and saved by the Company for 90 days after the date of creation, and deleted emails are saved and maintained by the Company for 14 days after the date of deletion. Thus, any undeleted emails that were received or created prior to June 30, 2002, which is more than 90 days prior to F&J's gathering of data on September 28, 2002, or any emails that were deleted more than 14 days prior to September 28, 2002, were not available unless stored by the employee to the hard drive of his or her desktop computer.

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The individuals from whom electronic data have been collected are:

1. Jean Davis	11. John Monteith
2. Mary Esclavon	12. Jessica Nantz
3. Lynn Fleming	13. Aimee Nichols
4. Patrick A. Foster	14. William T. ("Bill") Owens
5. Beall D. ("Nap") Gary, Jr.	15. Frederick L. ("Rick") Schmitt, Jr.
6. Brandon O. ("Brad") Hale	16. Richard M. Scrushy
7. Jason Hervey	17. Susan Jones-Smith
8. Pam Hodges	18. Weston L. Smith
9. William W. ("Bill") Horton	19. Larry D. Taylor
10. Malcolm E. ("Tadd") McVay	

#### C. Interviews

Fulbright & Jaworski L.L.P.'s efforts have also included conducting interviews. The following HealthSouth executives, employees, managers and members of the Board of Directors, as well as certain of the Company's outside agents and counsel, have been interviewed by F&J, some on more than one occasion:

1. Gary F. Capistrant (US Strategies)	11. M. Sean Huffman
2. John S. ("Jack") Chamberlin	12. John Monteith
3. Jean Davis	13. William T. ("Bill") Owens
4. Patrick A. Foster	14. Frederick L. ("Rick") Schmitt, Jr.
5. Thomas C. Fox (Reed Smith)	15. Richard M. Scrushy
6. Joel C. Gordon	16. Susan Jones-Smith
7. Brandon O. ("Brad") Hale	17. Larry Striplin, Jr.
8. Eric R. Hanson (US Strategies)	18. Larry D. Taylor
9. Scot T. Hasselman (Reed Smith)	19. Brad Traverse (US Strategies)
10. William W. ("Bill") Horton	

#### D. Other Sources

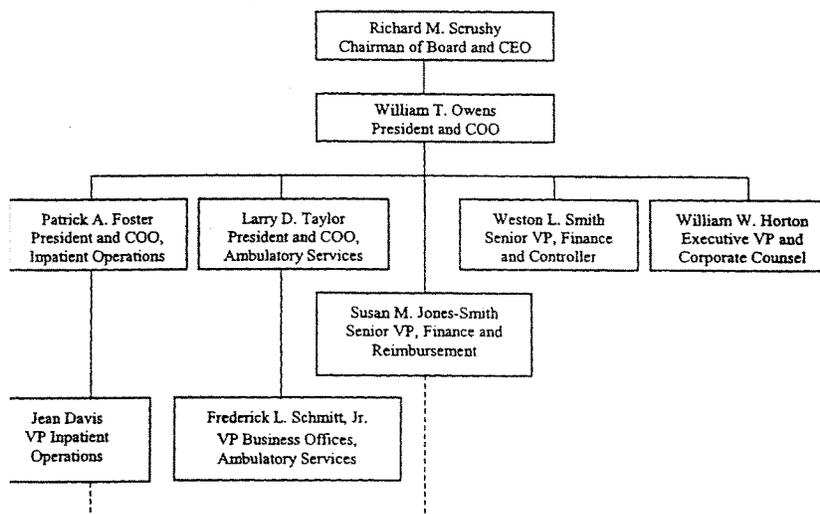
Although Fulbright & Jaworski L.L.P. did not attempt to make a comprehensive survey of publicly available material regarding either the Company or Transmittal 1753, F&J has consulted certain materials in addition to those listed above, including press releases, news reports, analyst reports and SEC filings.

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On October 4, 2002, Fulbright & Jaworski L.L.P. produced to the SEC an initial installment of approximately 3,460 documents obtained from the Company's corporate files, the Company's officers and directors, and the electronic data provided by the Company. On October 17, 2002, F&J produced to the SEC a summary of events relating to the matters covered by the SEC Request. Fulbright & Jaworski L.L.P. expects to supplement its initial production with additional documents on an ongoing basis.

## II. COMPANY ORGANIZATION AND REPORTING PROCESS DURING TIME PERIOD MAY 2002 THROUGH AUGUST 6, 2002

Fulbright & Jaworski L.L.P. has determined from its interviews with various members of senior management and review of documents that from May 2002 through August 6, 2002, the Company organization and reporting process relevant to Transmittal 1753 were as set forth in the chart below.



## III. SELECTED CHRONOLOGY AND FACTUAL FINDINGS

This section sets forth a chronology of selected events and also Fulbright & Jaworski L.L.P.'s factual findings through August 6, 2002, relevant to the issue of whether Mr. Scrushy was aware of the potential financial effect on the Company of Transmittal 1753.

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In June 1998, HealthSouth's primary Medicare intermediary, Blue Cross Blue Shield of Alabama ("BCBS-AL"), issued a publication entitled "Medicare Focus," which included the following language regarding billing for certain therapy services:

97150: Therapeutic procedure(s), group (2 or more individuals) 1. Since many group procedures do not require the professional skills of a provider, coverage of this procedure will be determined on a case-by-case basis. 2. Documentation must be submitted with the claim identifying the specific treatment technique(s) used in the group, how the treatment technique will restore function, the frequency and duration of the particular group setting, and the treatment goal in the individualized plan. The number of persons in the group must also be furnished.

On September 11, 1998, a meeting was held between HealthSouth and BCBS-AL representatives to discuss the June 1998 Medicare Focus and the instructions therein regarding billing for therapy services in the group setting.

On November 2, 1998, CMS (formerly the "Health Care Financing Administration" or "HCFA") published a final rule implementing a physician fee schedule-based payment system for therapy services, effective January 1, 1999, as required by Congress in the Balanced Budget Act of 1997.

In April 1999, CMS made publicly available draft Program Memorandum (Intermediaries/Carriers), Transmittal No. AB-99-, Change Request 842, which included the following language:

Group Therapy—Code 97150[.] The current policy has been to use the CPT definition of group therapy, 97150. We are concerned that some providers may not be familiar with the CPT definition, which may not be the same as their clinical concept of group therapy. CPT defines a group as treatment of two or more patients at the same time. If a therapist or physician performs any of the CPT Physical Medicine procedures with two or more individuals concurrently or during the same time period, then only 97150 is reported. . . . If a therapist or a physician performs the treatment on two or more patients during the same time period, or with the assistance of an aide or an assistant, the treatment must be reported using the group therapy code, 97150. For example, for a 25 minute group session of three patients being treated with aquatic therapy or therapeutic exercise, one unit of 97150 should be billed.

On June 18, 1999, HCFA held a "Listening Forum" at which the April 1999 draft Program Memorandum (Intermediaries/Carriers), Transmittal No. AB-99-, Change Request 842 was discussed.

On or about September 10, 1999, HealthSouth made a loan in the principal amount of \$25,218,114.87 to Mr. Scrushy, as evidenced by a promissory note of the same date, plus interest at the "Lender's Effective Rate" (as that term is defined in the note), with a maturity date of September 10, 2006 (the "Loan"). The Loan was provided pursuant to HealthSouth's 1999

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Executive Equity Loan Plan (the "Plan"). The stated purpose of the Plan was to provide a mechanism to enhance ownership of HealthSouth's common stock by executives and other key employees and to enable HealthSouth to retain such executives and key employees. Loans made under the Plan were only to be used to purchase HealthSouth common stock.

In March 2000, HCFA published final Program Memorandum (Intermediaries/Carriers), Transmittal AB-00-14, which did not contain any of the discussion in the April 1999 draft Program Memorandum regarding billing for group therapy services.

By letter dated November 7, 2000, HealthSouth's Medicare regulatory outside counsel, Thomas C. Fox of Reed Smith L.L.P. ("Reed Smith"), informed the Company that, "[w]hile HCFA may issue program guidance in the future, which defines group therapy in accordance with an earlier policy statement that was withdrawn, there is no current legal basis that would support a finding that HealthSouth's policies and procedures violate applicable Medicare laws and regulations."

On May 10, 2001, HCFA promulgated its proposed rule "Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities." 66 Fed. Reg. 23984 (May 10, 2001). In this proposed rule, HCFA included the following discussion in the preamble:

We note that there have always been isolated instances in which a professional therapist has been allowed to have some overlap in the time of concluding treatment to one individual and the time of commencing the treatment of another, even to the point of briefly providing therapy concurrently in certain cases. However, the key principle here is that Medicare relies on the professional judgment of the therapist to determine when, based on the complexity of the services to be delivered and the condition of the beneficiary, it is appropriate to deliver care to more than one beneficiary at the same time. Our concern now is that in some areas of the country, concurrent therapy is becoming a standard practice rather than the exception, and is being dictated by facility management personnel rather than according to the professional judgment of the therapists involved.

We believe it is important to heighten the SNF and therapy industries' awareness of the applicable Medicare policy in this regard. Medicare policy has not, until now, specifically addressed coverage of skilled rehabilitation therapy in situations in which a single professional therapist (or therapy assistant under the supervision of the professional therapist) simultaneously provides different treatments to multiple beneficiaries. As noted above, we have relied on the professional therapist's judgment as to when it is appropriate for an individual therapist to provide services to more than one beneficiary. We now wish to advise the providers of care of our concern about the potentially adverse effect of this practice on the quality of therapy provided to beneficiaries in Part A SNF stays, as well as our concern about the implications of making payments in such situations. We solicit public comments regarding the scope and magnitude of this problem, and possible approaches for addressing this issue.

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66 Fed. Reg. at 23992.

On July 31, 2001, CMS promulgated its final rule "Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities-Update." 66 Fed. Reg. 39561 (July 31, 2001). In this final rule, CMS stated in part:

We received a large number of comments encouraging us to continue to recognize concurrent therapy or skilled therapy. . . . However, we continue to believe, as do many of the commenters, that concurrent therapy has a legitimate place in the spectrum of care options available to therapists treating Medicare beneficiaries. Our goals are to safeguard the health and safety of beneficiaries and assure that they are provided the most effective, skilled care available. We agree that, at times, such care can be provided concurrently with another therapy patient, as long as the decision to do so is driven by valid clinical considerations.

66 Fed. Reg. at 39568.

On December 12, 2001, HealthSouth released its 2002 earnings objectives, raising its expectations for 2002 earnings per share to \$1.14 due to the expected effects of changes in government reimbursement practices and changes in the accounting for goodwill and intangible assets. This guidance was reiterated, in various forms, a number of times over the following four months.

Between March and May 2002, certain members of the Board of Directors, including Joel C. Gordon, John Chamberlin, Phillip C. Watkins, M.D., and Larry Striplin, Jr., impressed upon Mr. Scrusby the desirability of his repaying the Loan.

On April 29, 2002, during a meeting of the Corporate Compensation Committee, Mr. Owens advised the Committee that the Company had exhausted its efforts to find a way to extend Mr. Scrusby's options and that, because "there were no good choices to consider[,] . . . Mr. Scrusby may have to sell shares in the market."

On May 2, 2002, HealthSouth issued a press release in which it announced its "42% Growth in First Quarter EPS." The Company expressed that, "[g]iven these positive trends, we are actively pursuing additional strategic growth and development opportunities across our product lines. After a very successful 2001, the first quarter has positioned us well to move forward to a new level in 2002."

Prior to Mr. Scrusby's exercise of his options effective May 14, 2002, there were discussions beginning in the Fall, 2001, between Mr. Scrusby and numerous other individuals regarding whether he could properly extend certain options due to expire on May 15 and June 16, 2002, rather than exercise such options. Considerable effort was spent to determine whether Mr. Scrusby could properly extend the options before it was determined that he could not.

On May 14, 2002, Mr. Scrusby exercised options to purchase 5,275,360 shares of HealthSouth common stock. These represented options with an expiration date of May 15, 2002

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to purchase 2,275,360 shares under the 1991 Stock Option Plan and options with an expiration date of June 16, 2002 to purchase 3,000,000 shares under the 1992 Stock Option Plan. In each case, the exercise price of the options was \$3.7825 per share, for an aggregate exercise price of \$19,954,049.20. Mr. Scruschy sold these shares in a block trade on the date of exercise. On May 14, 2002, the average of the high and low prices of HealthSouth common stock was \$14.03 per share, indicating sale proceeds of approximately \$74,013,300.80 and net proceeds of approximately \$54,059,251.60. After the Option Exercise and Sale, Mr. Scruschy continued to own 15,629,595 shares of HealthSouth common stock and derivative securities.

On May 17, 2002, CMS issued Transmittal 1753, with the notation "NEW/REVISED MATERIAL" and an effective date of July 1, 2002. Transmittal 1753 instructs Medicare carriers in part as follows:

GROUP THERAPY SERVICES (CODE 97150)[,] Pay for outpatient physical therapy services (which includes outpatient speech-language pathology services) and outpatient occupational therapy services provided simultaneously to two or more individuals by a practitioner as group therapy services. The individuals can be, but need not be performing the same activity. The physician or therapist involved in group therapy services must be in constant attendance, but one-on-one patient contact is not required.

On June 6, 2002, Thomas C. Fox, Esq. of Reed Smith sent an email to Mr. Horton regarding pending *qui tam* litigation against the Company involving therapy services provided in the free-standing ambulatory care setting, not in the hospital setting, and possible legislative strategy relating to such litigation. Mr. Fox stated in part that "[s]ome strategic decisions need to be made [regarding Transmittal 1753] in the near term on how the company wants to approach these issues. I leave to you the need for decision making at the level of Richard [Scruschy] and/or Bill [Owens], but we want to be certain any legislative approach is fully aired within ther [sic] company." That same day, Mr. Horton, attaching the email from Mr. Fox, emailed Messrs. Owens, Smith and Taylor and Ms. Jones-Smith, stating that "[a]s soon as Bill [Owens] is back in the office, we need to discuss our planned response to the CMS Program Transmittal provision on Group Therapy described below. This is quite important." By email, Mr. Horton reiterated to Messrs. Owens, Smith and Taylor and Ms. Jones-Smith on June 15, 2002 that, "CMS has put out a program transmittal directing intermediaries to pay for any PT or OT services provided to two or more individuals as group therapy, even if the patients are performing different activities."

The days following June 15, 2002 included various email and other communications seeking an understanding among HealthSouth executives other than Mr. Scruschy, outside counsel and representatives from Medicare intermediaries and CMS regarding the impact of the "clarification of Transmittal 1753" on the provision of physical therapy services by HealthSouth.

On June 20, 2002, Ms. Jones-Smith called Dr. Greg McKinney, Medical Director for BCBS-AL, and inquired about the application of Transmittal 1753. According to Ms. Jones-Smith, Dr. McKinney stated that Transmittal 1753 applies only to physicians and individual therapists, and not to hospitals, rehabilitation agencies, or Comprehensive Outpatient Rehabilitation Facilities ("CORFs") furnishing therapy services. According to Ms. Jones-

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Smith, Dr. McKinney indicated that the purpose of Transmittal 1753 is "to educate physicians on group therapy and to make them aware of this code." Ms. Jones-Smith emailed a summary of her discussion with Dr. McKinney to Mr. Horton and Mr. Taylor on June 21, 2002. On June 25, 2002, Ms. Jones-Smith emailed Dr. McKinney and requested that he "[p]lease verify that [her] understanding [regarding their prior discussion about the application of Transmittal 1753] is correct, as we are trying to make every effort to ensure that we are complying with this transmittal to the extent it is applicable to us."

On June 26, 2002, Mr. Horton emailed Ms. Jones-Smith and stated his belief that "anything that is paid under Part B (incl. CORFs and rehab agencies) is covered by the new policy. Bill [Owens] and Weston [Smith] agree. I want to see what [Dr.] McKinney gives us in writing, if anything, but I am less and less comforted by what he told you before. I have recommended to Bill [Owens] that [the Company] proceed to modify [its] policies, and he agreed."

On the same day, Rick Schmitt notified Lynn Fleming, Ms. Jones-Smith, Patrick Foster, Chris Reading, Dan Riviere, Jessica Nantz, Marc Goff, Mike Rickman, Rick Katz, Sean Huffman, Larry Taylor, Aprile Edwards, and Matthew Zurek, that "[s]enior management has determined the new group code requirements that we have been discussing the past few days applies to us both in Part A and Part B as well as inpatient outpatient." Mr. Schmitt explained to F&J that his reference to "senior management" in the foregoing email was to Larry Taylor, President and Chief Operating Officer of HealthSouth's Ambulatory Services Division. As President of the Ambulatory Services Division, Mr. Taylor has primary responsibility for the Company's rehabilitation agencies and CORFs, although as a result of certain acquisitions by HealthSouth, he is also responsible for a few rehabilitation hospitals. Mr. Schmitt reports to Mr. Taylor, and not to the President of the Company's Inpatient Operations Division, Patrick Foster. See reporting process as described in Section II above. It appears, therefore, that Mr. Schmitt was addressing Transmittal 1753's potential application to the Company's Ambulatory Services Division, and not the Inpatient Operations Division.

Also on June 26, 2002, Lynn Fleming sent an email to Mr. Foster to which was attached a preliminary "Estimated Effect of Group Therapy Change Rehabilitation Hospitals – Outpatient Therapy." This preliminary estimate was prepared by Eudora Cannon, who estimated that Transmittal 1753 could impact the Company's net revenue for its rehabilitation hospitals between positive \$2,792,073 and negative \$22,894,995 for the time period July through December 2002.

On June 28, 2002, Dr. McKinney responded by email to Ms. Jones-Smith's request of June 25, 2002 for verification and stated that "[T]ransmittal [1753] was a clarification on [CPT code] 97150 for independent practitioners (MDs who perform the service or Independent PTs [physical therapists]). The definition of 97150 as per the CPT manual is applicable to all providers of this service." On the same day, Scot Hasselman, Esq. of Reed Smith recommended in an email to Mr. Horton that "HealthSouth decide (as soon as possible) what approach to take on this issue (i.e., the pm [Transmittal 1753] and July 1 effective rules on group therapy and aides) and provide appropriate policy direction to Gary [Capistrant of US Strategies]." On the same day, Mr. Horton described in a memorandum to the file that, after some discussion among

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William Owens, Weston Smith, Susan Jones-Smith and Patrick Foster, "a decision was made to continue seeking clarification from Blue Cross as to appropriate billing procedures and to refrain from changing any policies or procedures until further clarification was received."

At the end of June, 2002, Mr. Owens directed that all billing for therapy services in HealthSouth's ambulatory division be suspended until the Company could determine the applicability of Transmittal 1753. At or around this time, Mr. Owens believed that CMS may take the position that Transmittal 1753 applied to the physical therapy services HealthSouth provides in its CORFs and rehabilitation agencies, which are included in the Company's Ambulatory Services Division.

On or about June 30, 2002, Mr. Scrusby informed Brandon Hale of his willingness to repay the Loan prior to its maturity date of September 10, 2006. In the first week of July 2002, Mr. Scrusby informed Messrs. Owens and Horton of his willingness to repay the Loan, and asked Mr. Horton to effectuate the repayment. In mid-July 2002, Mr. Horton advised Mr. Scrusby that the Corporate Compensation Committee would need to approve the Loan Repayment, and he scheduled such a meeting for July 25, 2002.

In a letter dated July 5, 2002, in the context of the pending *qui tam* litigation against the Company involving therapy services furnished in the free-standing ambulatory care setting, not in the hospital setting, and possible legislative strategy relating to such litigation, Thomas C. Fox of Reed Smith informed HealthSouth that "the definition of Group Therapy to be effective July 1, 2002, would also apply to [HealthSouth's] hospital outpatient billings," and that "if HealthSouth were to continue to utilize the clinical standards followed in the past, which essentially limited billing under the Group Therapy Code only when two or more patients were treated at the same time with the same modality, as opposed to billing for concurrent therapy if the patients were treated with different modalities, the risk of liability for claims submitted by HealthSouth for services provided after July 1, 2002 is greatly increased, and could implicate [the Company's] rehab[ilitation] hospitals."

On July 7, 2002, Mr. Horton forwarded the July 5, 2002 letter from Mr. Fox to Messrs. Owens and Weston Smith and to Ms. Jones-Smith, and stated that he agreed with "Reed Smith's strong advice . . . that the recent group therapy transmittal should be read to apply to any non-PPS PT [Physical Therapy] or OT [Occupational Therapy] services." Mr. Horton further stated that he did "not believe what we have gotten from BCBS[-]AL is inconsistent with that or particularly helpful to us. I think we need to get clarification to the field on this right away, and I'd like to discuss this with you as soon as possible."

On July 8, 2002, the Company held its "Monday Morning Meeting," a regularly scheduled meeting at which approximately 65 to 100 of HealthSouth's managers make presentations of 30 seconds to two minutes each to the Chief Executive Officer and the President. The Monday Morning Meeting, which lasts approximately one and one half hours, is intended to generally inform the Chief Executive Officer and the President of any developments and activities for each executive and manager's region, division, or group from the period since the previous Monday Morning Meeting, and of their planned activities for the next several weeks. In advance of the meetings, the managers prepare an "Activity Report," outlining such

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developments and activities. The Activity Reports may be viewed by Mr. Scrusby during Monday Morning Meetings using a laptop computer as the presentations are made. According to her interview with F&J and her Activity Report, during her presentation at the July 8, 2002 Monday Morning Meeting, Ms. Jones-Smith addressed eight items including that she was "[w]orking with BCBS[-]AL on interpretation of various [M]edicare regulations ([T]ransmittal 1753 pertaining to Group Therapy). Steve Speil is arranging a meeting with CMS for us to discuss the various interpretations." Interviews with several members of management indicate that after Ms. Jones-Smith completed her presentation regarding Transmittal 1753, there was no follow-up discussion at the July 8, 2002 Monday Morning Meeting regarding Transmittal 1753 or Ms. Jones-Smith's reference thereto.

Also on July 8, 2002, the Hospital Association of Pennsylvania emailed Frank Dicesare, Ms. Jean Davis and Ms. Jones-Smith advising that it had "confirmation from Veritus Medicare today that Transmittal 1753 and specifically Group Therapy Services (code 97150), pertains to physician billing, not hospital billing. In other words, it does not apply to your outpatients that are receiving PT, OT, or SLP [Speech/Language Pathology] services at one of your outpatient satellites."

On July 11, 2002 the Company held a telephonic meeting of the Board of Directors to update the directors on a sharp decline in the price of HealthSouth common stock. The stock price had been falling since mid-June, and on July 11, 2002, the average of the high and low prices was \$8.95 per share. On the same day, HealthSouth issued a press release in which it announced that "it remained comfortable with consensus Wall Street estimates for the remainder of 2002."

On July 18, 2002, Steve Speil of the Federation of American Hospitals and Ms. Davis met with Tom Grissom of CMS in Washington, D.C., to discuss the applicability of Transmittal 1753 to the Company's various physical therapy services. Mr. Grissom asked Ms. Davis to provide him with follow-up information and promised Ms. Davis that he would look into the matter internally at CMS.

On the morning of July 24, 2002, Thomas C. Fox of Reed Smith sent an email to Mr. Horton in which he stated "[t]his is what I would say to Bill Owens (and Richard [Scrusby] if I had the opportunity). Unless and until Transmittal 1753 is withdrawn, outside counsel is telling the company it faces substantial risk of false claims liability by not following that coding and billing policy for therapy effective July 1, 2002."

Also on July 24, 2002, Mr. Horton sent an email to members of HealthSouth's Compensation Committee, *i.e.*, Mr. Striplin, Dr. Watkins and Mr. Chamberlin, and to Brandon Hale and advised them that "[l]ast month, Richard [Scrusby] paid the accrued interest on the loan and indicated that he wanted to satisfy the principal amount by transferring to the company shares with a value equal to the principal amount. . . . Because the Plan does not expressly provide for this method of repayment, the Compensation Committee needs to ratify this transaction."

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On July 25, 2002, Rick Schmitt communicated to certain HealthSouth personnel that, based on an extensive review by the Company, it had been determined that the billing code for group therapy must be used when billing Medicare if a therapist supervises more than one patient at a time.

Also on July 25, 2002, the Corporate Compensation Committee convened and Mr. Horton presented for the Committee's consideration the request by Mr. Scrusby to repay the principal amount of the Loan by transferring to the Company shares of HealthSouth common stock with a value equal to the principal amount of the Loan. Certain Compensation Committee members have indicated that Mr. Scrusby requested that the shares be calculated based upon the price of HealthSouth common stock at the time of his original request on June 30, 2002. HealthSouth common stock closed at \$12.79 per share on June 29, 2002. The average of the high and low trading price of HealthSouth common stock on July 25, 2002, was \$7.63 per share.

On July 26, 2002, Christopher Arrigo, MS, PT, National Director of Clinical Services, emailed to William Owens, William Horton, and Larry Taylor a document entitled "Clinical Considerations and Implications of Group Therapy Coding in the Medicare Population," which addressed the application of Transmittal 1753 to concurrent physical therapy furnished by the Company to Medicare patients.

On July 31, 2002, the Corporate Compensation Committee reconvened and approved the repurchase of shares from Mr. Scrusby to repay the principal of the Loan. Fulbright & Jaworski L.L.P. notes that neither the Company nor the Corporate Compensation Committee obtained a fairness opinion for the terms of the Loan Repayment, which may have been required pursuant to certain of the Company's debt instruments. The Loan Repayment was approved by the Corporate Compensation Committee at a share price equal to the average of the high and low trading price on July 31, 2002. The average of the high and low trading prices of HealthSouth common stock on July 31, 2002 was \$10.06 per share.

On August 1, 2002, Mr. Scrusby transferred 2,506,770 shares of HealthSouth common stock to HealthSouth in payment of the \$25,218,114.87 principal amount of the Loan.

Also on August 1, 2002, an internal memorandum entitled "Group Therapy" was distributed via email by Pam Hodges on behalf of William Owens to various Company personnel, including Patrick Foster, Larry Taylor and Christopher Arrigo, attaching a document entitled "Clinical Considerations and Implications of Group Therapy Coding in the Medicare Population," which addressed the application of Transmittal 1753 to concurrent physical therapy furnished by the Company to Medicare patients.

Mr. Owens stated that on August 6, 2002, he informed Mr. Scrusby of the existence of Transmittal 1753, its possible application to CORFs and rehabilitation agencies, and that if, as he believed would be the case, CMS would take the position that the Transmittal applied to CORFs and rehabilitation agencies, the financial impact on HealthSouth would be approximately \$10,000,000 to \$30,000,000. He further stated that HealthSouth had met with CMS officials in mid-July 2002 but left the meeting with "more questions than answers." Both Mr. Owens and Mr. Scrusby agreed that another meeting with CMS should be scheduled to seek further

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clarification from CMS on its interpretation of Transmittal 1753. Such a meeting was subsequently scheduled for August 15, 2002.

Mr. Owens has stated that he did not speak with Mr. Scrushy earlier about Transmittal 1753 because he did not believe that Transmittal 1753, and its potential financial impact of a reduction in earnings of approximately \$10,000,000 to \$30,000,000, was material or significant. He further stated that the reason he brought the matter to Mr. Scrushy's attention on August 6, 2002, was that Mr. Owens and HealthSouth's investment bankers were going to discuss a spin-off of HealthSouth's surgery division at the upcoming August 8, 2002 Board meeting. He believed that if there were such a spin-off, the possibility of a \$10,000,000 to \$30,000,000 reduction in earnings, while still not material, would be more significant to HealthSouth's remaining businesses and operations.

On August 7, 2002, the Company issued a press release that quoted Mr. Scrushy as saying that "[t]he second quarter showed strength across all product lines with each of our businesses demonstrating continued positive volume and pricing trends.... We were especially pleased with the performance of our inpatient rehabilitation facilities as they generated an 11% increase in revenue. This clearly demonstrates the success the [C]ompany is having under Medicare's new prospective payment system."

On August 8, 2002, at a regularly scheduled Board of Directors meeting, Mr. Scrushy (i) presented a plan for spinning off HealthSouth's surgery division; (ii) informed the Board of Transmittal 1753 and stated that it "appeared to change regulations for payment of group and concurrent therapy for outpatient Medicare reimbursement"; and (iii) advised the Board of his Loan Repayment under the 1999 Executive Loan Program by transferring shares to HealthSouth.

#### IV. CONCLUSION

The chronology set forth in Section III of this Review identifies that certain members of HealthSouth senior management other than Richard Scrushy had varying levels of knowledge of Transmittal 1753.

During the course of its Review, Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrushy was aware at the time of the Option Exercise and Sale, on May 14, 2002, of the pending issuance of Transmittal 1753. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrushy knew prior to the Loan Repayment, on July 31, 2002, of: (i) Transmittal 1753; (ii) the application of Transmittal 1753 to the Company's various outpatient therapy services; or (iii) the transmittal's potential financial effect on the Company, other than that Mr. Scrushy was present during a "Monday Morning Meeting" on July 8, 2002, during which the existence of Transmittal 1753 was referenced.

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Fulbright & Jaworski L.L.P. has prepared this letter solely for the purpose of informing the Board of Directors of its findings regarding the facts and circumstances surrounding the Option Exercise and Sale and the Loan Repayment by Mr. Scrushy. The Board of Directors should not view anything in this letter as a conclusion with respect to the potential outcome of any regulatory investigation or legal action. Fulbright & Jaworski L.L.P. expresses no views as to the inferences that may be drawn from the facts and circumstances contained in this Review. In addition, please note that this letter is not a comment on any other matter Fulbright & Jaworski L.L.P. reviewed or may be asked to review in the future.

Very truly yours,

Fulbright & Jaworski L.L.P.

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HHEC16/0127

**FULBRIGHT & JAWORSKI L.L.P.**

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October 29, 2002

**Privileged and Confidential:  
Attorney Work Product Doctrine Applies**

**BY HAND DELIVERY**

The Board of Directors of HealthSouth Corporation  
One HealthSouth Parkway  
Birmingham, Alabama 35243

Ladies and Gentlemen:

As part of Fulbright & Jaworski L.L.P.'s (or "F&J") continuing review of HealthSouth Corporation ("HealthSouth" or the "Company"), pursuant to its engagement, the Board of Directors of HealthSouth requested that by October 22, 2002, Fulbright & Jaworski L.L.P. set forth its findings regarding the facts and circumstances surrounding the exercise of options and sale of HealthSouth common stock by Richard M. Scrusby on or about May 14, 2002 and the transfer of HealthSouth common stock to HealthSouth by Mr. Scrusby in satisfaction of the principal of a loan from HealthSouth on or about July 31, 2002 (the "October 21, 2002 Review"). F&J delivered the October 21, 2002 Review to the Board on October 22, 2002.

The conclusion set forth in Section IV of the October 21, 2002 Review states in part:

During the course of its Review, Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby was aware at the time of the Option Exercise and Sale, on May 14, 2002, of the pending issuance of Transmittal 1753. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby knew prior to the Loan Repayment, on July 31, 2002, of: (i) Transmittal 1753; (ii) the application of Transmittal 1753 to the Company's various outpatient therapy services; or (iii) the transmittal's potential financial effect on the Company, other than that Mr. Scrusby was present during a "Monday Morning Meeting" on July 8, 2002 during which the existence of Transmittal 1753 was referenced.

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The Board of Directors of HealthSouth Corporation  
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Upon its review and consideration of the October 21, 2002 Review, the Board has requested that Fulbright & Jaworski L.L.P. assess, to the extent ascertainable, additional facts and circumstances relating to the "Monday Morning Meeting" (as that term is defined below and in the October 21, 2002 Review) which was held at the Company's corporate offices on July 8, 2002, and in particular, any report or presentation which was made at such meeting which mentioned or discussed Transmittal 1753 or the policy contained therein. This letter sets forth F&J's findings from such inquiry, and supplements F&J's letter dated October 1, 2002 and the October 21, 2002 Review. The entire contents of the October 21, 2002 Review are incorporated into and made a part of this letter as though set forth in full herein.

The chronology set forth in Section III of the October 21, 2002 Review identifies that certain members of HealthSouth senior management other than Richard Scrushy had varying levels of knowledge of Transmittal 1753. This finding is not modified by the findings set forth in this letter. Should F&J discover any facts or circumstances that are material to the matters expressed in this letter or in the October 21, 2002 Review with respect to Mr. Scrushy, F&J will supplement its findings. At your request, Fulbright & Jaworski L.L.P. continues its Review of certain matters relating to Transmittal 1753.

#### I. INTERVIEWS OF CERTAIN HEALTHSOUTH PERSONNEL CONCERNING THE JULY 8, 2002 MONDAY MORNING MEETING

Fulbright & Jaworski L.L.P. has interviewed the following HealthSouth personnel concerning the facts and circumstances surrounding the July 8, 2002 Monday Morning Meeting, some more than once: Brooks Adams, Jean Davis, Patrick A. Foster, Brandon O. ("Brad") Hale, Jason Hervey, William W. ("Bill") Horton, M. Sean Huffman, Malcolm E. ("Tadd") McVay, Frederick L. ("Rick") Schmitt, Richard M. Scrushy, and Susan Jones-Smith. Set forth below are the results of these interviews.

On July 8, 2002, the Company held its "Monday Morning Meeting," a regularly scheduled meeting that is held approximately once a month, at which approximately 65 to 100 of HealthSouth's managers make presentations of 30 seconds to two minutes each to the Chief Executive Officer and the President. The Monday Morning Meeting, which usually lasts approximately one and one half to two hours, is intended to generally inform the Chief Executive Officer and the President of any developments and activities for each executive and manager's region, division, or group for the period since the previous Monday Morning Meeting, and of the planned activities for each manager making a presentation for the next several weeks. In advance of the meetings, the managers prepare an "Activity Report," outlining such developments and their own activities. The Activity Reports may be viewed by Messrs. Scrushy and Owens during Monday Morning Meetings using a laptop computer as the presentations are made. The managers who make oral presentations often report on some but not all of the contents of their "Activity Report" during the 30 seconds to 2 minutes allotted to each of them for their presentations.

According to her interviews with F&J and her Activity Report, during her presentation at the July 8, 2002 Monday Morning Meeting, Ms. Jones-Smith addressed eight different subjects.

The Board of Directors of HealthSouth Corporation  
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Ms. Jones-Smith has stated that the focus of her presentation at the July 8, 2002 Monday Morning Meeting was to announce that HealthSouth's cash collections were at a "record high" of over one-billion dollars in that financial quarter, that she was "excited" about announcing this fact, and that she began her presentation with the expression "Good news." Also, Ms Jones-Smith's Activity Report stated that she was "[w]orking with BCBS[-]JAL on interpretation of various [M]edicare regulations ([T]ransmittal 1753 pertaining to Group Therapy). Steve Speil is arranging a meeting with CMS for us to discuss the various interpretations." Ms. Jones-Smith has explained that she read this statement verbatim in approximately 16 seconds at the July 8, 2002 Monday Morning Meeting, and that her entire presentation at that meeting, consisting of each of the eight different subjects, lasted, in total, approximately "one minute or so." She has stated that she usually reads "directly" and "verbatim" from her Activity Report, and "pretty much sticks to what is on her [Activity] Report," when she makes her presentations at the Monday Morning Meetings. She has stated that after her presentation at the July 8, 2002 Monday Morning Meeting, there was no follow-up discussion regarding Transmittal 1753 at that meeting.

According to Ms. Jones-Smith, no one at the July 8, 2002 Monday Morning Meeting would have had "any reason" to focus on her reference to Transmittal 1753 or to have known what Transmittal 1753 was, unless they had already been made aware of the group therapy issue. She identified such HealthSouth personnel as Rick Schmitt, Bill Horton, Larry Taylor and Jean Davis. She further stated that she did not intend for anyone other than these HealthSouth personnel "to pay attention" to the reference to Transmittal 1753. Ms Jones-Smith stated that she only mentioned Transmittal 1753 so that these HealthSouth personnel would know that she was working on the matter. She further recalled that she used the term "group therapy" in conjunction with the term Transmittal 1753 because she realized that the reference to Transmittal 1753 itself was "meaningless" to the attendees at the meeting, with the exception of the HealthSouth personnel who had already been made aware of the group therapy "issue."

With the exception of Ms. Jones-Smith, no other HealthSouth personnel whom F&J has interviewed has stated that they mentioned Transmittal 1753 or any issue relating to group therapy at the July 8, 2002 Monday Morning Meeting.<sup>1</sup> Attendees of the July 8, 2002 Monday Morning Meeting, other than Ms. Jones-Smith, have described their recollections of what they heard Ms. Jones-Smith say, or not say, about Transmittal 1753 or any issue concerning group therapy at that meeting as follows:

- Mr. Adams has stated that he did not hear Ms. Jones-Smith mention Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting, and that Ms. Jones-Smith first mentioned Transmittal 1753 either during the August 27, 2002 Monday Morning Meeting or following that meeting.

<sup>1</sup> It should be noted that the last entry on Mr. Horton's Activity Report for the June 17, 2002 Monday Morning Meeting states: "Follow up with Operations and Reimbursement on new Medicare Carriers Manual language re: group therapy." However, Mr. Scrushy did not attend the June 17, 2002 Monday Morning Meeting. In addition, Mr. Horton has stated that he does not recall making any statement regarding Transmittal 1753 or any issue concerning group therapy at a Monday Morning Meeting.

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- Ms. Davis has stated that she does not recall Ms. Jones-Smith or anyone else mentioning Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting, and that July 8, 2002 was her first day back from vacation. She has also indicated that if she herself discussed Transmittal 1753 or any issue concerning group therapy at any Monday Morning Meeting, it would have been reflected in her Activity Report for such meeting. The only Activity Report for Ms. Davis that mentions any issue concerning group therapy is her report for the August 20, 2002 Monday Morning Meeting, which states, in part: "Meet with CMS, w S. Smith and L. Taylor on outpatient reimbursement changes."
- Mr. Foster has stated that he recalls Ms. Davis mentioning Transmittal 1753 or the group therapy issue at a Monday Morning Meeting held on August 20, 2002 or "more likely" September 9, 2002, and that he recalls Ms. Jones-Smith mentioning Transmittal 1753 during her presentation at a Monday Morning Meeting prior to the one at which Ms. Davis mentioned Transmittal 1753 or the group therapy issue. He has stated that he does not recall the exact date of the meeting at which Ms. Jones-Smith mentioned Transmittal 1753, but that at the time of that meeting, "it wasn't a big deal," and he is "sure" it was after she had received an email from Blue Cross Blue Shield of Alabama on the subject.
- Mr. Hale has stated that he did not hear Ms. Jones-Smith mention Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting.
- Mr. Hervey has stated that he did not hear Ms. Jones-Smith mention Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting.
- Mr. Horton has stated that he does not recall Ms. Jones-Smith mentioning Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting.
- Mr. Huffman has stated that he did not hear Ms. Jones-Smith mention Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting, that he takes detailed notes of the matters mentioned at the Monday Morning Meetings, and that his notes do not reflect that Ms. Jones-Smith mentioned either subject.
- Mr. McVay has stated that he did not hear Ms. Jones-Smith mention Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting, that he is "primarily focused" on his own presentations at the Monday Morning Meetings, and that when he is not presenting, he focuses on "work that [he] brings with [him] to the meetings."
- Mr. Schmitt has stated that he "honestly do[es] not remember" whether Ms. Jones-Smith mentioned Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting.

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- Mr. Scrusby has stated that Ms. Jones-Smith "did not say anything" about Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting.
- Mr. Taylor has stated that he does not recall Ms. Jones-Smith mentioning Transmittal 1753 or any issue concerning group therapy at the July 8, 2002 Monday Morning Meeting. He has stated that the term "Transmittal 1753" did not have any "special meaning" to him on July 8, 2002 even though he had heard the term before and, prior to July 8, 2002, he was working on the definition of "group therapy" and the application of Transmittal 1753 thereto.

The Activity Reports for the Monday Morning Meetings are available for inspection.

## II. CONCLUSION

In view of the October 21, 2002 Review and the Board's request that Fulbright & Jaworski L.L.P. make further inquiry with respect to the matters contained herein, and based on the additional factual findings set forth above, Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby was aware at the time of his option exercise and sale of HealthSouth common stock on May 14, 2002, of the pending issuance of Transmittal 1753. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrusby knew prior to the time of the transfer by Mr. Scrusby of HealthSouth common stock to HealthSouth on or about July 31, 2002, in satisfaction of the principal amount of a loan made to him by HealthSouth under its 1999 Executive Equity Loan Plan, of: (i) Transmittal 1753; (ii) the application of Transmittal 1753 to the Company's various outpatient therapy services; or (iii) the transmittal's potential financial effect on the Company.

Fulbright & Jaworski L.L.P. has prepared this letter solely for the purpose of informing the Board of Directors of its findings regarding the facts and circumstances surrounding the July 8, 2002 Monday Morning Meeting and whether, and to what extent, Transmittal 1753 or the policy addressed therein was mentioned or discussed at such meeting. The Board of Directors should not view anything in this letter as a conclusion with respect to the potential outcome of

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any regulatory investigation or legal action. Fulbright & Jaworski L.L.P. expresses no views as to the inferences that may be drawn from the facts and circumstances contained in this letter. In addition, please note that this letter is not a comment on any other matter Fulbright & Jaworski L.L.P. reviewed or may be asked to review in the future.

Very truly yours,

Fulbright & Jaworski L.L.P.

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October 29, 2002

Tab 107

**Privileged and Confidential:  
 Attorney Work Product Doctrine Applies**

The Board of Directors of HealthSouth Corporation  
 One HealthSouth Parkway  
 Birmingham, Alabama 35243

Ladies and Gentlemen:

On October 21, 2002, at the request of the Board of Directors of HealthSouth Corporation ("HealthSouth" or the "Company"), Fulbright & Jaworski L.L.P. (or "Fulbright") submitted its findings regarding the facts and circumstances surrounding the exercise of options and sale of HealthSouth common stock by Richard M. Scrusby on or about May 14, 2002 and the transfer of HealthSouth common stock to the Company by Mr. Scrusby in satisfaction of the principal amount of a loan from HealthSouth on or about July 31, 2002 (the "October 21, 2002 Review"). The Board of Directors has asked that Fulbright & Jaworski L.L.P. assess, to the extent ascertainable, the facts and circumstances relating to the destruction of documents at HealthSouth subsequent to the receipt on September 17, 2002 of a request from the Securities and Exchange Commission (the "SEC") for certain documents pertaining to an investigation of HealthSouth's August 27, 2002 announcement (the "SEC Request") that was referred to in the October 21, 2002 Review.

**DISCOVERY OF DESTROYED DOCUMENTS**

On September 26, 2002, Fulbright attorneys reviewing files in a file room containing files of Brandon O. ("Brad") Hale (Executive Vice President Administration, Corporate Secretary and Compliance Officer), Malcolm E. ("Tadd") McVay (Chief Financial Officer), William Owens (Chief Executive Officer) and Weston Smith on the fifth floor of the Executive Office Tower (the "Executive Level"), noticed a large and a small shredder. Each shredder contained shreds in its collection bag (the "September 26<sup>th</sup> Materials"). When some of the shredded material was examined, such phrases as "mital 1753" and "175 m" were noted. Some of the shreds appeared to be from e-mail documents. There was no indication of when the documents had been shredded. The Fulbright attorneys removed the contents of each shredder and took custody of them. The aggregate amount of shreds collected from both shredders fit into one banker's box.

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On October 2, 2002, Fulbright attorneys observed a Company employee shredding documents in the Network Services copier room, located in the North Wing of the third floor. Later that day a large bag of shreds was discovered in the same copier room beside a shredder, apparently awaiting ordinary pick-up by cleaning personnel. The Fulbright attorneys removed the bag from the corporate offices and took custody of it.

#### SCOPE OF FULBRIGHT'S SUPPLEMENTAL REVIEW

At the Company's request, Fulbright has sought to determine whether the shredding of the documents that were discovered on September 26 and October 2, 2002, or of any other documents, was done outside the routine and ordinary course of HealthSouth's business. In that regard, on October 23 and 24, 2002, Fulbright performed an inquiry and conducted interviews relating to HealthSouth's document retention efforts from September 17, 2002 to early October 2002.

Between October 23 and October 24, 2002, two Fulbright attorneys visited the HealthSouth Corporate headquarters in Birmingham and interviewed in person or by telephone, (i) Mary Esclavon, Assistant to Mr. Scrushy, Susan Evans, Assistant to Tom Carmen, Executive Vice President of Mergers and Acquisitions, Brandon Hale, Pam Hodges, Assistant to Mr. Owens, Malcolm McVay, William Owens, and Kathee Parks, Assistant to Messrs. Hale, McVay and Weston Smith; (ii) all Fulbright attorneys who discovered destroyed documents at HealthSouth during the course of Fulbright's Review; (iii) James Goodreau, Director of Corporate Security, HealthSouth Corporate, and Les Moore, Assistant Director of Security; and (iv) Lea Patterson, Lead Cash Coordinator for Group Health Claims, Network Services Department.

#### FACTUAL FINDINGS

Prior to the receipt of the SEC Request, HealthSouth did not have a formal, written policy regarding the retention and destruction of non-electronic documents. However, in consideration of: (i) common law individual privacy protections and federal requirements regarding the confidentiality of certain Medicare patient information (42 C.F.R. § 482.13(d)(1) ("The patient has the right to the confidentiality of his or her clinical records."), Medicare Hospital Manual 413 ("To insure the confidentiality of the [patient] records, destroy them by shredding, mutilation or other protective measures."); (ii) the federal Health Insurance Portability and Accountability Act of 1996 ("HIPAA") security and privacy requirements (security requirements are in proposed rule form; mandatory compliance with the privacy requirements begins April 14, 2003); and (iii) in accordance with standard practices in the healthcare industry, HealthSouth routinely destroyed documents that contained private data regarding its patients. In addition, HealthSouth executives routinely destroyed documents that contained financial data or information they otherwise regarded as strategic or proprietary, including draft minutes of meetings of the Company's board of directors, draft press releases and draft contracts.

HealthSouth received the SEC Request on September 17, 2002 and retained Fulbright on September 18, 2002.

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The Board of Directors of HealthSouth Corporation  
 October 29, 2002  
 Page 3

On September 19, 2002, Fulbright requested orally and in writing that the Company act immediately to preserve documents.<sup>1</sup> On September 20, 2002, William W. Horton, Executive Vice President and General Counsel, directed all HealthSouth personnel to:

IMMEDIATELY take all steps necessary to ensure that all documents electronic files and e-mails under your control are preserved until we can ensure that all relevant documents have been appropriately gathered and reviewed . . . [P]lease make sure that nothing you control is destroyed or deleted. There is no need to send any documents anywhere at this time in connection with our review . . . . Again, strict compliance with this memorandum is critical.

On October 2, 2002, Lea Patterson, Lead Cash Coordinator for Group Health Claims, Network Services Department, destroyed material containing private and confidential patient information. In consideration of common law individual privacy protections and the federal requirements regarding the confidentiality of certain Medicare patient information, it has been the common practice of Network Services to periodically destroy patient identifying information by shredding relevant documents. Ms. Patterson stated to Fulbright that she believed the document retention memorandum she received from Mr. Horton was limited to email. Ms. Patterson also stated that she has not destroyed any documents since October 2, 2002, and displayed to Fulbright a cubicle filled with several boxes of computer printouts.

Fulbright notified Mr. Horton of its discoveries of shredded documents on September 26 and October 2, 2002, on the evening of October 2, 2002. On the same day, at the request of Fulbright, Mr. Horton sent another company-wide memorandum reiterating a "no-shredding" policy.

On or about October 3, 2002, when Richard M. Scrusby was advised of the shredding, he ordered James Goodreau, Director of Corporate Security, HealthSouth Corporate, to seize every shredder (approximately 50) in HealthSouth's corporate headquarters and to secure them under lock and key. Each of the sequestered shredders contained some amount of shredded materials. Mr. Goodreau undertook and completed this task on or about the same day and communicated such to Mr. Scrusby and to Mr. Horton by e-mail on October 4, 2002. Mr. Goodreau stated to Fulbright that HealthSouth has suspended all shredding of any documents in the corporate headquarters until the completion of the SEC investigation. See Attachment A (reports prepared by Mr. Goodreau).

Prior to October 3, 2002, many and perhaps most executives in the fifth floor Executive Level had small shredding machines in their offices, typically of the variety that fits on top of a

<sup>1</sup> A shareholder derivative action and the first of several class action complaints relating to the Company's August 27, 2002 announcement were filed against the Company on August 28, 2002. On September 3, 2002, Mr. Horton received an email from Michael Rediker, Esq., of the law firm Haskell Slaughter Young & Rediker, regarding the pending litigation and advising the Company, among other things, to suspend normal disposal and document retention policies during the pendency of the litigation with respect to relevant or even potentially relevant electronic files and paper files and to move relevant e-mails to a secure storage.

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 Page 4

wastebasket. Shredding machines also were available in at least two file rooms on the Executive Level. In addition, each executive has a "shred basket" the contents of which, prior to October 3, 2002, were collected and destroyed by Mr. Goodreau and other Executive Level staff as needed. Mr. Goodreau and all other Executive Level staff have informed Fulbright that they have not shredded documents in months, and Fulbright's examination of the contents of several shred baskets appeared to support that statement. *See, for example, Attachment B* (inventory of contents of William Owens' shred basket).

William W. Horton's October 2, 2002 memorandum generated a number of questions from the Company's facilities regarding routine shredding of materials not related to the SEC investigation. Mr. Horton in turn sought guidance from Fulbright as to how the Company might balance the preservation of documents and information relevant to Fulbright's Review and the SEC's Request against the Company's obligations to protect patients' privacy and confidentiality. In an email to Fulbright on October 2, 2002, Mr. Horton wrote:

I sent out a company-wide memo reiterating a "no-shredding" policy. This has, not unexpectedly, generated a flood of questions from our facilities, ranging from the mundane ("Have questions:

Your direction not to shred anything. At the facility level we generate massive amounts of paperwork in the normal course of our daily routine. For example, copy of drivers [sic] license, insurance cards. Typically these are front and back. Naturally, in process of copying both sides you have duplicate of one side. WE also have errors on fee tickets which must be corrected. Did you intend to include this type of information in direction to not shred?

Do you have guidance on storage of such material that would normally be shredded?")

[T]o the profound ("Could you please explain/clarify how with this directive we are supposed to comply with the HIPAA laws that require shredding/proper disposal of documents containing patient information.").

I would appreciate your prompt guidance on what will satisfy you, and what in your view will satisfy the SEC, etc., since we produce a vast quantity of irrelevant paper that must be disposed. In particular, I would appreciate hearing whether you have any concern about the routine paperwork at the facility level. Your attention and response will be appreciated.

On October 8, 2002, Fulbright provided HealthSouth with guidance regarding its document retention policy pending its Review and the SEC's investigation. Among other things, Fulbright advised that:

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"[R]outine paperwork at the facility level" does not necessarily have to be retained in consideration of this firm's review and the pending SEC investigation. It would appear to be sufficient if the strict prohibition against the shredding of documents would only apply to the files of the following [HealthSouth] personnel and their secretaries and personal assistants: (i) all Executive Officers; (ii) Ambulatory Services East and West, Inpatient Operations, and Corporate Office: (a) Senior Vice Presidents, (b) Group Vice Presidents, (c) Vice Presidents, (d) Regional Vice Presidents, and (e) Assistant Vice Presidents; (iii) John Monteith (if he is not otherwise covered under the personnel categories herein); and (iv) individual HealthSouth hospital chief executive officers and chief financial officers. With one possible exception explained herein, other [HealthSouth] personnel should continue to treat company documents consistent with both federal law, including but not limited to the Medicare hospital conditions of participation applicable to medical record services codified at 42 C.F.R. 482.24 (as interpreted in Medicare Hospital Manual 413), and the company's existing document retention policy. The possible exception is that any [HealthSouth] employees that have any documents in any way relevant to the company's August 27, 2002 press announcement must preserve such documents.

Fulbright's complete guidance is set out in full in Attachment C.

Correspondence between Fulbright and Mr. Horton continued from October 8, 2002 through October 14, 2002 in order to develop the details of a policy that would be as conservative as possible with regard to the preservation of documents pending Fulbright's Review and the SEC investigation, yet nevertheless be sensitive to the Company's business needs and privacy obligations. On October 15, 2002, Mr. Horton distributed a further memorandum clarifying the documents to be retained. The text of Mr. Horton's October 15, 2002 memorandum is set out in Attachment D.

#### RECONSTRUCTION OF DOCUMENTS

Fulbright has attempted to determine whether it is feasible to reconstruct the shredded documents Fulbright removed from HealthSouth's offices. The contents of the smaller shredder in the Executive Level file room were cut into strips approximately one-eighth of an inch wide. The contents of the larger shredder in the Executive Level file room and the contents of the bag from the Network Services copy room were cross-cut into pieces approximately one-eighth of an inch by one inch. Fulbright has contacted several third-party vendors that offer document reconstruction services. One such vendor, Corefacts, estimated that this material could be reconstructed in two to three weeks, although it cannot be guaranteed that they can completely reconstruct the contents of each bag.

#### CONCLUSION AND RECOMMENDATIONS

HealthSouth is required by federal regulations and common law individual privacy protections to ensure patients' privacy and the confidentiality of their medical information. HealthSouth routinely destroys documents containing certain patient information in order to

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The Board of Directors of HealthSouth Corporation  
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comply with these requirements and protections. The only clear instance Fulbright discovered of shredding during this period was in the Network Services Department on October 2, 2002. Fulbright is unable to determine when any other documents were destroyed, why they were destroyed, who destroyed them or what was contained in the destroyed documents.

Fulbright recommends that the HealthSouth Board of Directors: (1) implement a formal document retention policy and, as a temporary measure during the SEC investigation, take steps to ensure the preservation of all documents potentially relevant to the SEC investigation; (2) preserve and catalog all material in the shredders currently impounded at HealthSouth's corporate headquarters as well as the material removed by Fulbright; (3) ascertain when to provide this report to the SEC pursuant to their investigation; and (4) consider the retention of an independent third-party vendor to attempt reconstruction of: (a) the September 26<sup>th</sup> Materials, and (b) a random selection of other selected shredded materials.

Fulbright & Jaworski L.L.P. has prepared this letter solely for the purpose of informing the Board of Directors of its findings regarding the destruction of documents by HealthSouth personnel subsequent to September 17, 2002. The Board of Directors should not view anything in this letter as a conclusion with respect to the potential outcome of any regulatory investigation or legal action. Fulbright & Jaworski L.L.P. expresses no views as to the inferences that may be drawn from the facts and circumstances contained in this letter. In addition, please note that this letter is not a comment on any other matter Fulbright & Jaworski L.L.P. reviewed or may be asked to review in the future.

Very truly yours,

Fulbright & Jaworski L.L.P.

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Attachment A

Report by James Goodreau

## HEALTHSOUTH

One HEALTHSOUTH Parkway  
Birmingham, AL 35243

### MEMORANDUM

TO: File  
FROM: Jim Goodreau  
DATE: October 3, 2002

SUBJECT: Shredder documents in fifth floor file room

---

I assigned Scott Pierce (Security) to escort/assist the outside attorney group while they reviewed items in the fifth floor file room. Scott advised me that the attorneys removed items from that file room and did not want him in the room while they searched it. They asked him to leave the room and shut the door. Scott stated that he observed the attorneys collect and remove shredded materials that were located inside the shredder in the file room. It is important to note that the shredder in that area is very large and seldom requires the contents be removed. Therefore, the materials that were removed could be items shredded over a period of several months, as this shredder is very rarely used.

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—Original Message—

From: Goodreau, Jim  
Sent: Friday, October 04, 2002 10:10 AM  
To: Scrusby, Richard  
Cc: Horton, Bill  
Subject: FYI

All shredders at the Corporate office have been secured in a room on the 1 st floor, this includes shredders that were in individual offices. Access to this room is limited to Les Moore and myself, and the room has 24 hour video coverage. In addition, you asked me to look into a situation which took place on the third floor north area of Network Services. Lea Patterson of Network Services did shred some items, however, those items contain proprietary information which accompanies the Group Health Capitation Checks. This is membership information which contains social security numbers, names, and the date of birth of the individual covered. We are required under the Privacy Act to ensure the aforementioned information is properly disposed of in order to protect the privacy of the individual. It has been the common practice of Network Services to periodically destroy these records by shredding them. There will be no shredding of any documents in the Corporate Offices until the completion of the SEC investigation.

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Goodreau, Jim

From: Patterson, Lea  
Sent: Thursday, October 03, 2002 4:24 PM  
To: Goodreau, Jim; Moore, Les  
Subject: Shredding

Per our conversation, I would like to reaffirm I did shred on October 2, 2002. I was disposing of proprietary information which accompanies the Group Health Capitation Checks. This is membership information which contains social security numbers, names, and dates of birth. I shredded approximately 4 reams of membership prior to receiving the email requesting we retain all documents. This membership will continue to come with the capitation checks and will need to be stored somewhere off site eventually as we discussed.

LEA PATTERSON  
LEAD CASH UNIT COORDINATOR  
1-800-634-8536 EXT. 3530  
1-205-262-3928. FAX  
LEA.PATTERSON@HEALTHSOUTH.COM

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Attachment B

## Inventory of William Owens's Shred Basket

Date	Document
10/21/2002	Activity Report
10/02/2002	Itinerary for trip to D.C for Bill Owens, Dan Riviere, Rob Tillman and Susan Smith
10/02/2002	Email from Bill Horton to Bill Owens, William McGahan regarding attached draft press release
10/01/2002	Emails from Sean Huffman to MdeCarlo@methodistsports.com regarding meetings and group therapy
09/24/2002	Payor Contracting and Support - contract breakdown by Operating Area
09/24/2002	Letter from B V Clemons (AAPT) to Bill Owens
09/20/2002	Letter from Charlene Portee (AAPT) to Bill Owens
09/19/2002	Final - HealthSouth Corporation Conference Call
09/09/2002	Will Hicks HealthSouth Investment Overview PowerPoint printout
06/1998 - 09/2002	Timeline
08/13/2002	Email from BridgetS@comphealth.com to Bill Owens; cnewhall@nea.com; Pam Hodges; and mambrose@nea.com regarding CompHealth Board Meeting
06/28/2002 - 08/02/2002	Workers' Compensation Current Lost Time Report
07/24/2002	Email from Bill Horton to ldsjr66@aol.com; phil390@bellsouth.net; jackchamberlin@aol.com and Brad Hale regarding Information for Compensation Committee Meeting
07/20/2002	Memo from Judy Dean to Bill Owens and Susan Jones regarding National Charts/Graphs from 45 day AR hit list - Surgery and Diagnostic
07/15/2002	Model Assumptions - Income statements and transaction summaries
07/15/2002	Revised - Model Assumptions - Income statements and transaction summaries
07/12/2002	Memo from Tadd McVay to R. Scrushy, B. Owens, W. Smith, E. Harris, B. Horton, R. Davis and J. Brown regarding Debt Repurchases

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07/09/2002	Meeting Agenda (post-it "Bill O." and "Tom Williams Porsche \$544.87")
Jul-02	Project Longhorns Overview Power Point printout
Jul-02	UBS Warburg Project Longhorns Discussion Materials
06/21/2002	Memo from Richard Davis to Bill Owens, Tadd McVay, Weston Smith, Emery Harris, Bill Horton, Jason Brown, Catherine Fowler regarding Fixed to Floating Swap
06/17/2002	Lost Time Cases Review Over 6 Weeks
11/21/01 - 05/21/02	Trade Line
05/17/2002	Email from John Dwyer to Bill Owens regarding attached Revised Term Sheet
04/29/2002	Pro Forma - Proposed (post-it "Marc Goff, Jessica Nantz")
04/25/2002	Inland Marine Service Order
04/24/2002	Email from Scott Wollard to Thom Carman, Roderick Oneill regarding The Fitness Company
04/24/2002	Project FIT printout
04/12/2002	Letter from Bruce Fischman to Gerald Scrushy regarding HealthSouth ADA Cases
Apr-02	Summary Description & Financial Information
Apr-02	HealthSouth Corporation Discussion Materials - UBS Warburg
03/31/2000 - 2002	Internal Projections
03/31/2002	Facility Incentive Plan
03/19/2002	Memo from Scott Wollard (UBS Warburg) to Bill Owens regarding remarks on accretion/dilution model, income statement analysis and wall street consensus
03/19/2002	UBS Warburg Transaction Overview- Crimson
03/15/2002	Recommended Promotions - Board of Directors Meeting
03/12/2002	Revised Draft of 10-K
03/12/2002	Press Release "HealthSouth Announces Record Revenues; Operating Earning Per Share of \$2.22, up 16% for Fourth Quarter"
03/09/2002	Internal Memo from Weston Smith to Bill Owens re FIT Due Diligence
03/07/2002	Physician Activity Report - Uribe, Constance Gail, MD
03/07/2002	Physician Activity Report - Farrell, Patrick, Unk
03/07/2002	Physician Activity Report - Herr, Timothy Mark, MD
03/07/2002	Physician Activity Report - Miller, Louis Mark,

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	MD
03/04/2002	Email from Kim Kettl to Jessica Nantz regarding Pet Scans
03/01/2002	Fax from Eric Hanson to Bill Owens regarding attached letter of recommendation
02/28/2002	Volume Comparison - Impatient Discharges by Market Leader
02/28/2002	Salary - Actual vs. Budget spreadsheet
02/28/2002	Letter from Robert Montgomery to Bill Owens regarding Polawana Property
02/28/2002	Volume Comparison - Total By Market Leader and Manager
02/27/2002	Letter from Larry Lanford (Jefferson County Commission) to Bill Owens regarding political support
02/26/2002	Letter from William Horton to Dorian Daley (Oracle) regarding Termination of Strategic Partnership
02/22/2002	Memo from Brett Grauss to Bill Owens attaching a HCA Proposal
02/22/2002	Workers' Compensation Current Lost Time Report
02/19/2002 - 02/21/2002	Cullman Surgery Center - opposition letters
02/20/2002	Memo from Jack Hawkins to Members of the Board of Trustees regarding attached article from the Alabama School Journal
01/23/2002	Letter from George Pugh to Rick Katz and Peggy Wellman regarding fate of the funds at Summit Bank
2001 - 2002	HealthSouth Hospitals of Las Vegas Combined Financials
2002	Facility Examples
07/25/2001	Options and Awards Summary (post-it "from Brad Hale")
07/03/2001 - 07/21/2001	Employee Expense Report - William Owens (Post-It "Replacement Exp Rpt. From Kay M.)
04/30/2001	HealthSouth - Rob Thomson - Income Statement (New Store; Same Store 02,03,04,05,06; Medical Center; Same Store Impatient; Same Store Outpatient; Same Store Surgery; Same Store Diagnostic)
04/30/2001	HealthSouth - Larry Taylor - Income Statement (New Store; Same Store 02,03,04,05,06; Medical Center; Same Store Impatient; Same Store Outpatient; Same Store Surgery; Same Store Diagnostic)

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04/30/2001	HealthSouth - Pat Foster - Income Statement (New Store; Same Store Impatient; Same Store Outpatient; Same Store Surgery; Same Store Diagnostic)
03/31/2001	Per Working Day Analysis - Encounters and Expenses (post-it "Bill Owens -complete set")
03/31/2001	Per Working Day Analysis - Encounters and Expenses (post-it "Pat Foster")
02/28/2001	EBITDA spreadsheet
2001	Draft letter to Eugene Smith regarding termination of employment with HealthSouth
n/a (2001)	Partners/projected increase in distribution
2Q00 - 2Q01	Consolidated Statements of Income Comparison Summary
05/24/2000	Walt Disney World Coronado Springs Resort - 2003 Contract Cancellation
04/26/1999	Invoice - Yamaha of Sylacauga
06/01/98	Medicare Focus Journal - Important Information for Medicare Providers
08/13	Phone Message for Bill from Darby
August	Patient Feedback Summaries
n/a	Facility Financial Report
n/a	HealthSouth Counteroffer on Purchase of Doctors Hospital by University of Miami
n/a	HealthSouth Surgery Center of Hillon Head, L.P. PowerPoint printout (post-it "For Bill Owens from Suzanne)
n/a	Post-it
n/a	Phone Message for Bill from Mary
n/a	Business Card of Ken Woodby - Pilot Aviation Department
n/a	paper shred with phone number 310-454-6591
n/a	
n/a	MapQuest.com directions
n/a	Draft License Agreement between HealthTech, Inc. and HealthSouth Corporation
n/a	Power Point slide printout
n/a	JPMorgan Executive Summary Power Point printout
n/a	Power Point slide printout - New Ideas to Strategically Grow Markets
n/a	PT State Analysis - Plan B
n/a	Check shreds
n/a	Project Bulldogs Term Sheet
n/a	Project Bulldogs Key Shareholder Returns

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n/a	Note - "PHICO Almost Bankrupt Insurance Company in PA - Faith"
n/a	HET Roll Out PowerPoint Printout
n/a	HealthSouth & HET Revenue Analysis
n/a	EPS Sensitivity Analysis on CRIMSON
n/a	Miscellaneous email page(?) (Post-it "From Randy Mink - Has not been sent. Has been reviewed & approved (clinically))
n/a	Year 1 - 4 quarter spreadsheet
n/a	Draft HS-HET Strategic Agreement between NET, Inc. and HS Corporation
n/a	Draft Promotion Agreement between HealtheTech, Inc. and HealthSouth Corporation
n/a	2004-2006 HealthSouth Administrators Meeting Locations Plan
n/a	Draft CMS Capital Ventures, Inc. Consent in Lieu of Special Meeting of Stockholders (note "Bill- FYJ Will Hicks has signed this in your absence")
n/a	PowerPoint presentation printout
n/a	PowerPoint presentation printout (post-it "for Bill's Review")
n/a	Proposed Promotions
n/a	PowerPoint presentation printout (post-it "Bill- your presentation for tommorrow with notes on Deta - Jes")
n/a	Budget Bonus Plan
n/a	photocopies of notebook pages
n/a	SEC Form 10-K HealthSouth Corporation
n/a	Phone Message for Bill from Thom
n/a	cell phone care charger
n/a	candy wrappers

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Guidance from Fulbright & Jaworski L.L.P. regarding document retention

"[R]outine paperwork at the facility level" does not necessarily have to be retained in consideration of this firm's review and the pending SEC investigation. It would appear to be sufficient if the strict prohibition against the shredding of documents would only apply to the files of the following HealthSouth personnel and their secretaries and personal assistants: (i) all Executive Officers; (ii) Ambulatory Services East and West, Inpatient Operations, and Corporate Office; (a) Senior Vice Presidents, (b) Group Vice Presidents, (c) Vice Presidents, (d) Regional Vice Presidents, and (e) Assistant Vice Presidents; (iii) John Monteith (if he is not otherwise covered under the personnel categories herein); and (iv) individual HealthSouth hospital chief executive officers and chief financial officers. With one possible exception explained herein, other HealthSouth personnel should continue to treat company documents consistent with both federal law, including but not limited to the Medicare hospital conditions of participation applicable to medical record services codified at 42 C.F.R. 482.24 (as interpreted in Medicare Hospital Manual 413), and the company's existing document retention policy. The possible exception is that any HealthSouth employees that have any documents in any way relevant to the company's August 27, 2002 press announcement must preserve such documents.

The federal Health Insurance Portability and Accountability Act of 1996 ("HIPAA") includes both security and privacy requirements. The disposal of documents containing protected health information is addressed in the HIPAA proposed security regulation (63 Fed. Reg. 43242 (Aug. 12, 1998)). The Centers for Medicare & Medicaid Services ("CMS"), however, has not yet promulgated these requirements in a final rule, and thus, these requirements at the present time do not have the force of law. Until CMS publishes a final rule implementing the security requirements, HealthSouth is not strictly required to comply with the proposed requirements. Of course, the company may decide to follow now the security requirements even though only proposed. If this is the case, and you desire specific guidance regarding attempting to adhere to these proposed security requirements, please let us know, and we will furnish you with more detailed compliance guidance.

The HIPAA privacy requirements govern the use and disclosure of protected health information (for example, information regarding demographics, and the physical or mental condition of an individual). While these requirements do not specifically address the issue of the proper disposal of documents containing protected health information, the requirements do include other provisions (for example, the rights of patients to access and amend their files), which may affect how a "covered entity" under the HIPAA requirements disposes of its records. The HIPAA privacy requirements became effective on April 14, 2001 (65 Fed. Reg. 82462), with certain modifications to these requirements to become effective October 15, 2002 (67 Fed. Reg. 53182). However, health care providers are not strictly required to comply with the privacy requirements until April 14, 2003. Again, the company may decide that it will now attempt to follow the HIPAA privacy requirements even though not strictly required to do so until next year. If so, and you want specific compliance suggestions from us, please let us know.

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Attachment D

Memorandum from William W. Horton, Esq. regarding document retention

## MEMORANDUM

FROM: Bill Horton  
EVP & Corporate Counsel

DATE: October 15, 2002

RE: Document Retention/Disposition/Shredding

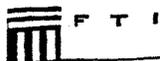
This is a further clarification to my previous memoranda regarding the preservation of documents. For purposes of this clarification and except as otherwise specified below, "documents" generally should be considered to be written materials, including letters, memoranda, email correspondence, and notes, either prepared by or sent to Company personnel relating to: (i) clinical protocols or coding, billing, or reimbursement instructions relating to therapy services provided in either the freestanding setting (rehabilitation agencies and comprehensive outpatient rehabilitation facilities) or the hospital setting; (ii) accounting policies; (iii) filings with the Securities and Exchange Commission; and (iv) trading in the Company's securities. The term "documents" excludes newspapers, magazines, seminar brochures, junk mail, or similar materials not related to the matters described in (i) - (iv) above. Until further notice from Richard Scrusby, Bill Owens, or me, there must not be any destruction, removal, or other disposition of any documents in the personal possession or control of the following persons (including their secretaries or assistants): (a) all corporate officers, whether based in the corporate office or in the field; and (b) all facility administrators and controllers/CFOs.

In addition, (i) there must not be any destruction, removal, or other disposition of any documents in the corporate office, regardless of who possesses or controls such documents, until further notice from one or more of the above-listed individuals; and (ii) under no circumstances should anyone at any location destroy, remove, or otherwise dispose of any documents relevant to the subject matter of our August 27 public announcement concerning the impact of Medicare Program Transmittal 1753, group therapy coding, and the proposed tax-free separation of our surgery center division and related management changes. All other documents not related to the matters described in this paragraph and the preceding paragraph, including documents containing patient identifying information or other protected health information, should be handled in accordance with applicable law and the Company's existing document retention policies and may be destroyed or otherwise disposed of in accordance with such policies. Thank you for your assistance in helping us ensure that all documents that we are required to maintain and preserve in connection with pending investigations and litigation are appropriately handled, and for your patience and cooperation during this process. Please contact me directly if you have any questions regarding the proper treatment of any particular document(s) under this clarification.

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FTI Consulting  
 Martin L. Cohen  
 1201 Eye Street  
 NW Suite 400  
 Washington, DC 20005  
 Telephone (202) 312 9230  
 Facsimile (202) 312 9108

Tab 108

TO: William Owens  
 President and Chief Executive Officer  
 HealthSouth Corp.

FROM: Martin L. Cohen, FTI Consulting

DATE: November 6, 2002

RE: Fulbright & Jaworski Report - Open Items and Follow-up Questions From  
 Earnings Announcement

Dear Mr. Owens:

In order to finalize our report to Fulbright and Jaworski, we have prepared the following information request list. The list combines information outstanding from our fieldwork as well as new requests based on metrics that the Company released in Tuesday's earnings announcement. With respect to the latter, we need to better understand how the metrics released in the earnings announcements reconcile to the information in our report.

The following are key economic and statistical metrics that were referenced in your third quarter call:

- i. 3Q2002 to 3Q2001 17% decline in outpatient rehabilitation revenue.
- ii. 3Q2001 to 3Q2002 14% decline in outpatient rehabilitation volume.
- iii. 3Q2001 to 3Q2002 2.2 M to 2.058 M decline in outpatient rehabilitation visits.
- iv. 3Q2001 to 3Q2002 8.3% decline in outpatient rehabilitation visits.
- v. 3Q2001 to 3Q2002 3.8% decline in "same store" outpatient rehabilitation visits.
- vi. \$98/visit to \$89/visit decline in net revenues per visit.
- vii. \$23M impact due to Transmittal 1753.
- viii. 2Q2002 to 3Q2002 \$34M-volume impact.
- ix. 2Q2002 to 3Q2002 11K decline in referrals.
- x. 2Q2002 to 3Q2002 visits per discharge decline of one per discharge.
- xi. \$10M impact on inpatient division due to Transmittal 1753.

To facilitate the reconciliation of the above metrics with our report we would like the following information:

1. Clarification regarding which of these metrics refers to: (i) freestanding clinics, (ii) hospital outpatient and (iii) hospital satellite facilities;

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 HealthSouth Corp.

HHEC 44-1119

Apr-28-02 10:14am From: SASMF LLP 2023717096 T-79E P 005/007 4-01E  
**FTI**  
 William Owens  
 November 6, 2002 Page 2

2. Supporting documentation and the opportunity to meet with the staff who prepared the above mentioned metrics;
3. Identification of any non-recurring or one-time contractual adjustments and/or changes to reserves for doubtful accounts during 3Q2002?
4. Revenue reconciliation's (at the detail trial balance level) for outpatient rehabilitation including: (i) freestanding clinics, (ii) hospital outpatient and (iii) hospital satellite facilities) for 3<sup>rd</sup> Qtr 2002 and 3<sup>rd</sup> Qtr 2001. As part of this analysis we would like to see the breakout, by major payor category, of the following:
  - a. Gross charges
  - b. Contractual adjustments and other contra-revenue adjustments
  - c. Net revenue
5. Underlying data for the referral and visit volume comments included in the press release and the earnings conference call. In order to better understand this, we would propose the following:
  - a. A year-over-year analysis of the following key metrics for the period 7/1/01 - 10/31/01 compared to 7/1/02 - 10/31/02:
    - i. Changes in visits per discharge
    - ii. Same store visit volume
    - iii. Trend in admissions

In addition, the HealthSouth IT group has created an Oracle database for the period January 2002 through June 2002. We suggest that this database be updated with patient billing data for the period July 1, 2002 thru October 31, 2002 and July 1, 2001 thru October 31, 2001 to facilitate the above-mentioned analyses. The database should include all existing data structures, existing data fields and include two new data fields (1): Admission date, and (2) Discharge date.

Please call me at (240) 460-3452 to discuss our request.

CC: Hal Hirsch, Esq., Fulbright & Jaworski LLP  
 Thomas Dowdell, Esq., Fulbright & Jaworski LLP  
 Dominic DiNapoli, FTI Consulting  
 Debbie Smith, FTI Consulting

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Confidential Treatment  
 Requested by  
 HealthSouth Corp.

HHEC 44-1120

<p style="text-align: right;">Page 10</p> <p>1 them because I don't have a clue who they are.                  2 MR. LOOMIS: None of them are in the room, Your                  3 Honor. But Michael Vines is a witness, Teresa Sanders is a                  4 witness, and Diane Henze, H-e-n-z-e, is also a witness.                  5 MR. HICKS: And we have an FBI agent named Greg                  6 Gauger.                  7 THE COURT: Are any of these people in here?                  8 Okay.                  9 MR. SJOBLOM: Your Honor, may I?                  10 Mrs. Scrusby has been subpoenaed. I don't know --                  11 THE COURT: All right. She probably needs to wait                  12 outside. She'll wait in the witness room too.                  13 MR. SJOBLOM: Are you intending to call her?                  14 MR. HICKS: Yes. That's possible.                  15 MR. WATKINS: Your Honor, may I ask a procedural                  16 question?                  17 THE COURT: No, sir. You may have a seat. I'm                  18 ready to proceed.                  19 MR. HICKS: Okay. We would call Mr. Scrusby.                  20 THE COURT: All right.                  21 Would you please -- What you need to do is just come in                  22 here and stand until you are sworn and then state your name.                  23 THE WITNESS: That's fine.                  24 RICHARD MARIN SCRUSHY                  25 was sworn/affirmed and testified as follows:</p>	<p style="text-align: right;">Page 11</p> <p>1 BY THE COURTROOM DEPUTY:                  2 Q. Will you state your full name for the record?                  3 A. Richard Marin, M-a-r-i-n --                  4 THE COURT: Wait, wait. Would you speak up?                  5 THE WITNESS: Yes, ma'am.                  6 A. Richard Marin, M-a-r-i-n. Scrusby, S-c-r-u-s-h-y.                  7 Q. The city and the state where you live?                  8 A. Okay. I live in Vestavia, Alabama.                  9 THE COURT: Good morning.                  10 THE WITNESS: Good morning.                  11 DIRECT EXAMINATION                  12 BY MR. HICKS:                  13 Q. Good morning, Mr. Scrusby. I don't believe we've ever                  14 met. I'm Bill Hicks. I represent the SEC.                  15 Are you the founder of HealthSouth Corporation?                  16 MR. SJOBLOM: Your Honor, I object and instruct the                  17 witness to assert his Fifth Amendment right against                  18 self-incrimination.                  19 THE COURT: Okay.                  20 A. On advice of --                  21 THE COURT: Wait, wait, wait. You don't have to                  22 answer that.                  23 MR. HICKS: I'm sorry. I don't know how to --                  24 THE COURT: Well, I assume his lawyer asserted on                  25 his behalf.</p>
<p style="text-align: right;">Page 12</p> <p>1 MR. HICKS: All right. Fair enough.                  2 THE COURT: Do you understand that that's what you                  3 want to do is take the Fifth Amendment?                  4 THE WITNESS: Yes, ma'am.                  5 THE COURT: Okay.                  6 MR. HICKS: Your Honor, I'm not going to waste a lot                  7 of the Court's time. I'm just going to ask a few --                  8 THE COURT: I don't have anything but time. So you                  9 are not wasting anybody's time. This is not a matter of                  10 looking at it that way. This is serious. And I don't have                  11 anything but time, so don't think about whether or not you're                  12 wasting my time, because nobody is wasting my time.                  13 MR. HICKS: That's good. I've never had a judge say                  14 that to me.                  15 THE COURT: All right.                  16 BY MR. HICKS:                  17 Q. Did HealthSouth Corporation go public in 1986?                  18 MR. SJOBLOM: Objection, Your Honor, and instruct                  19 the witness not to answer and to assert his Fifth Amendment                  20 right against self-incrimination.                  21 Q. What positions have you held at HealthSouth Corporation                  22 MR. SJOBLOM: Objection, Your Honor. Same                  23 objection. And rather than me popping up and down, I just                  24 have a continuing objection to any question.                  25 THE COURT: You actually do have to state it each</p>	<p style="text-align: right;">Page 13</p> <p>1 time. I'm sorry. But this is hard for the court reporter to                  2 do.                  3 MR. SJOBLOM: Do you mind my standing?                  4 THE COURT: No, I don't mind. You do not have to                  5 stand while you do it.                  6 MR. SJOBLOM: All right. I think I'll stand for a                  7 little while.                  8 THE COURT: Okay.                  9 BY MR. HICKS:                  10 Q. Have you held other outside employment since 1986?                  11 MR. SJOBLOM: Objection, Your Honor, and instruct                  12 the witness not to answer and to assert his Fifth Amendment                  13 right against self-incrimination.                  14 Q. Did you sign annual current and periodic reports filed                  15 with the SEC during your tenure at HealthSouth?                  16 MR. SJOBLOM: Objection, and instruct the witness                  17 not to answer and to assert his Fifth Amendment right against                  18 self-incrimination.                  19 Q. Did you sign registration statements filed with the                  20 Commission with respect to HealthSouth?                  21 MR. SJOBLOM: Objection, and instruct the witness                  22 not to answer and to assert his right against                  23 self-incrimination under the Fifth Amendment.                  24 I'll deviate just a little bit to make it a little more                  25 interesting.</p>

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<p>1 THE COURTROOM DEPUTY: There's a chair over there.                  2 MR. MAYS: Okay. Thank you.                  3 THE COURT: Well, he doesn't want to sit on that                  4 side.                  5 (Laughter.)                  6 MR. MAYS: I'll sit there.                  7 THE COURT: All right. Wherever you want to sit,                  8 but I don't want you to have to sit way back.                  9 All right. And let's see who we've got for the                  10 defendant. Are there any representatives here from                  11 HealthSouth other than the U. S. attorney?                  12 MR. MAYS: I don't believe so, Your Honor.                  13 THE COURT: Okay.                  14 Is Mr. Scrusby in the courtroom?                  15 THE COURTROOM DEPUTY: Yes.                  16 THE COURT: All right. Good morning.                  17 And he's represented by Lewis Gillis?                  18 MR. GILLIS: Yes, ma'am.                  19 THE COURT: James Richey? Okay. You don't have a                  20 seat up here by counsel table either, huh?                  21 MR. RICHEY: That's all right. We've got enough up                  22 there, I think.                  23 THE COURT: Okay.                  24 Scott Balber?                  25 MR. BALBER: Yes, Your Honor.</p>	<p>1 paperwork?                  2 MR. HICKS: That's fine.                  3 THE COURT: Okay.                  4 This is a hearing set on plaintiff's petition for                  5 emergency relief. And are you ready to proceed?                  6 MR. HICKS: We are, Your Honor.                  7 THE COURT: Okay.                  8 Let the record show that the defendant Scrusby filed a                  9 motion for partial listing of an assets freeze order, and a                  10 request to limit this hearing, and an amended motion which                  11 was filed in court. And I have not ruled on that motion. I                  12 have not set that motion for hearing. I want to know whether                  13 the plaintiffs have any comment or any response to a motion                  14 to limit this hearing?                  15 MR. HICKS: Well, I'm sorry. I didn't catch what                  16 it's limited to.                  17 THE COURT: Just a hearing on whether or not the                  18 assets that have presently been frozen of Mr. Scrusby can                  19 be -- Well, let me make sure this is correct.                  20 MR. WATKINS: Your Honor, I'd be happy to give an                  21 overview.                  22 THE COURT: No. I'm sorry. I didn't ask for                  23 anything.                  24 They are not ready to proceed on the entire petition for                  25 emergency relief because they said they have not had enough</p>
Page 7	Page 9
<p>1 THE COURT: All right.                  2 Donald Watkins?                  3 MR. WATKINS: Yes, Your Honor.                  4 THE COURT: Gary Baise?                  5 MR. BAISE: Yes, Your Honor.                  6 THE COURT: And then I think there are some that                  7 have not been admitted pro hac vice yet.                  8 MR. ROSE: That's correct, Your Honor.                  9 THE COURT: If you would identify yourself for her,                  10 please, I'd appreciate it.                  11 MR. ROSE: Jonathan Rose, Your Honor. Good                  12 morning.                  13 THE COURT: Good morning.                  14 MR. SJOBLOM: Thomas Sjoblom, Your Honor. Good                  15 morning.                  16 MR. McDermott: Robert McDermott, Your Honor.                  17 THE COURT: All right. Good morning.                  18 I have not had a chance to look through your motions that                  19 were filed 12 minutes ago, so I have not actually admitted                  20 you yet. I haven't had a chance to.                  21 Let me ask the plaintiff's counsel: Is there any problem                  22 with these gentlemen participating subject to them being                  23 admitted pro hac vice?                  24 MR. HICKS: No, Your Honor.                  25 THE COURT: Subject to when I have time to do the</p>	<p>1 discovery.                  2 MR. HICKS: We do object to limiting that. That's                  3 one of the elements we have to show on a freeze, that there's                  4 some likelihood of success on the merits.                  5 THE COURT: Okay.                  6 I'm ready to proceed with your original motion. Are you                  7 ready to call your first witness?                  8 MR. HICKS: Are we going to have opening                  9 statements?                  10 THE COURT: No.                  11 MR. HICKS: We call Mr. Scrusby.                  12 THE COURT: All right.                  13 MR. HICKS: Oh. Your Honor, I would invoke the                  14 rule.                  15 THE COURT: Okay. Are there any witnesses in here                  16 who are going to testify?                  17 Do you know of any witnesses other than Mr. Scrusby?                  18 MR. SJOBLOM: Yes, Your Honor. Depending on what                  19 happens. Obviously, we don't know the government's case, but                  20 we have a possible clarification, witness impeachment --                  21 THE COURT: All right. Whoever you know at this                  22 point since the rule has been invoked, they need to wait in                  23 the witness room.                  24 MR. HICKS: We've got some other witnesses also.                  25 THE COURT: Okay. Well, would you just identify</p>

<p style="text-align: right;">Page 14</p> <p>1 THE COURT: All right.                  2 BY MR. HICKS:                  3 Q. In signing those reports, did you verify that the                  4 financial statements contained in the reports were accurate?                  5 MR. SJOBLOM: Objection, and instruct the witness                  6 not to answer and to assert his right against                  7 self-incrimination.                  8 Q. When you signed those reports, did you get the complete                  9 report before you at the time you signed it, or just the                  10 signature page?                  11 MR. SJOBLOM: Objection. Instruct the witness not                  12 to answer, and to assert his right under the Fifth Amendment                  13 against self-incrimination.                  14 THE COURT: Okay. Now, let me remind you, Counsel,                  15 that I do have in this file Mr. Scrusby's deposition where                  16 he's testified to these matters under oath.                  17 MR. SJOBLOM: I understand.                  18 THE COURT: All right. That is in the file and that                  19 is evidence in this case already.                  20 MR. SJOBLOM: Well, I haven't seen --                  21 THE COURT: I just want you to know that. You were                  22 not counsel of record at the time --                  23 MR. SJOBLOM: Okay.                  24 THE COURT: -- but it is filed with the Court. And                  25 it has been considered by the Court, and it is evidence in</p>	<p style="text-align: right;">Page 16</p> <p>1 THE COURT: Okay.                  2 Q. Were you aware that HealthSouth's financial statements                  3 were given to the banks during that period?                  4 MR. SJOBLOM: Objection, and instruct the witness                  5 not to answer and to assert his right against                  6 self-incrimination under the Fifth Amendment.                  7 Q. Did you and others at HealthSouth agree that HealthSouth's                  8 earnings, or any derivation of earnings, were income -- would                  9 be artificially inflated?                  10 MR. SJOBLOM: Again, we would object and instruct                  11 him not to answer and to assert his right against                  12 self-incrimination under the Fifth Amendment.                  13 BY MR. HICKS:                  14 Q. Did you ever give anyone instructions to alter the                  15 numbers in various accounts at HealthSouth to artificially                  16 inflate?                  17 MR. SJOBLOM: Objection, and instruct the witness                  18 not to answer and to assert his right against                  19 self-incrimination under the Fifth Amendment.                  20 Q. Were you given preliminary reports on HealthSouth's real                  21 earnings prior to quarterly or annual reports being filed?                  22 MR. SJOBLOM: Objection, and instruct the witness                  23 not to answer and to assert his right against                  24 self-incrimination under the Fifth Amendment.                  25 BY MR. HICKS:</p>
<p style="text-align: right;">Page 15</p> <p>1 this case.                  2 MR. SJOBLOM: It's admitted?                  3 THE COURT: Yes.                  4 MR. SJOBLOM: Okay. I would still stand on my                  5 objection that even if the transcript is in evidence, what                  6 he's asking this witness to say now is something totally                  7 different. It's yet another form of testimony. He has a                  8 right to assert his Fifth Amendment.                  9 THE COURT: Oh absolutely. I'm not saying he has.                  10 But what I have in front of me is a transcript of his                  11 testimony given under oath where he testified that he did                  12 sign the statement and that he got only the signature page                  13 and he assumed that they were prepared in accordance with the                  14 rules and regulations. And at this point, to the same                  15 question, I have an assertion of the Fifth Amendment.                  16 I just want you to be aware of the fact that those are                  17 the two things that I have in front of me right now.                  18 MR. SJOBLOM: I understand, Your Honor.                  19 THE COURT: All right.                  20 BY MR. HICKS:                  21 Q. Were you aware during your tenure at HealthSouth that                  22 HealthSouth was obtaining loans from various banks?                  23 MR. SJOBLOM: Objection, Your Honor, and instruct                  24 the witness not to answer and to assert his right against                  25 self-incrimination under the Fifth Amendment.</p>	<p style="text-align: right;">Page 17</p> <p>1 Q. Did those reports indicate a gap or variance with Wall                  2 Street expectations?                  3 MR. SJOBLOM: Objection, and instruct the witness                  4 not to answer and to assert his right against                  5 self-incrimination under the Fifth Amendment.                  6 Q. Did you instruct Mr. Owens, Mr. Smith, or any employee to                  7 alter the results in the reported numbers or to fix an                  8 earnings shortfall?                  9 MR. SJOBLOM: Objection, and instruct the witness                  10 not to answer and to assert his right against                  11 self-incrimination under the Fifth Amendment.                  12 Q. Prior to the filing of this case, were you aware that any                  13 of HealthSouth's financial statements filed with the                  14 Commission were inaccurate?                  15 MR. SJOBLOM: Objection, and instruct the witness                  16 not to answer and to assert his right against                  17 self-incrimination under the Fifth Amendment.                  18 Q. If you had found out that any HealthSouth employee was                  19 altering the numbers, would you have fired him?                  20 THE COURT: You may answer that.                  21 A. Yes.                  22 MR. HICKS: Your Honor, for the record, I want to                  23 state that if he's going to answer some questions on this                  24 topic, I think he's waived his Fifth Amendment to all of                  25 them.</p>

<p style="text-align: right;">Page 18</p> <p>1 THE COURT: I know what you think.                  2 MR. HICKS: Well, I move that then.                  3 THE COURT: All right.                  4 BY MR. HICKS:                  5 Q. Did you know that a group of your employees who called                  6 themselves "the family," were meeting periodically to discuss                  7 how to artificially inflate HealthSouth earnings?                  8 MR. SJOBLOM: Objection. Instruct the witness not                  9 to answer and to assert his right against self-incrimination                  10 under the Fifth Amendment.                  11 THE COURT: All right.                  12 BY MR. HICKS:                  13 Q. Did you ever tell the board or anyone that Wall Street                  14 wanted to see 20 percent annual growth?                  15 MR. SJOBLOM: Objection, and instruct the witness                  16 not to answer and to assert his right against                  17 self-incrimination under the Fifth Amendment.                  18 Q. Did you meet with Mr. Owens and the chief financial                  19 officer in August 2002 to discuss the need for the CFO to                  20 sign a management certification regarding the second quarter                  21 10-Q?                  22 MR. SJOBLOM: Objection. Instruct the witness not                  23 to answer and to assert his right against self-incrimination                  24 under the Fifth Amendment.                  25 Q. Did Mr. McVay or Mr. Owens indicate that they had any</p>	<p style="text-align: right;">Page 20</p> <p>1 MR. HICKS: Yes. I'll try to say it.                  2 Q. Were you aware that HealthSouth had a Form 10-Q or an                  3 amendment due during the last two weeks of March 2003. When                  4 I say are you aware, I mean at the time.                  5 MR. SJOBLOM: I object to that and instruct the                  6 witness not to answer and to assert his right against                  7 self-incrimination under the Fifth Amendment.                  8 THE COURT: All right. Are you getting that, Ms.                  9 Flowers?                  10 THE COURT REPORTER: I'm having trouble hearing.                  11 THE COURT: All right. Do you want to move closer?                  12 You're not getting a whole lot of answers here.                  13 (Laughter.)                  14 MR. SJOBLOM: Good morning.                  15 THE COURT REPORTER: Good morning.                  16 THE COURT: Speak up. Okay?                  17 MR. SJOBLOM: All right.                  18 THE COURT: All right.                  19 BY MR. HICKS:                  20 Q. During the last two weeks in March 2003, did you have                  21 discussions with Mr. Owens about a 10-Q being due?                  22 MR. SJOBLOM: Objection, and instruct the witness                  23 not to answer and to assert his right against                  24 self-incrimination under the Fifth Amendment of the United                  25 States Constitution.</p>
<p style="text-align: right;">Page 19</p> <p>1 problem with signing it?                  2 MR. SJOBLOM: Objection. Instruct the witness not                  3 to answer and to assert his right against self-incrimination                  4 under the Fifth Amendment.                  5 BY MR. HICKS:                  6 Q. Did HealthSouth have a Form 10-Q or an amendment to a                  7 Form 10-Q due during the last two weeks of March 2003?                  8 MR. SJOBLOM: I missed part of that. Could I have                  9 it read back, please?                  10 BY MR. HICKS:                  11 Q. Did HealthSouth have a Form 10-Q or an amendment to a                  12 Form 10-Q due during the last two weeks of March 2003?                  13 MR. SJOBLOM: I think we can stipulate --                  14 THE COURT REPORTER: I'm sorry?                  15 THE COURT: Okay. He said I think we can stipulate                  16 that as a public company they would probably have had to file                  17 a form at the end of the first quarter of 2003, March 31st.                  18 Is that what you are doing? You said you think you can                  19 stipulate. Are you stipulating?                  20 MR. SJOBLOM: I'll stipulate to the fact that the                  21 company had to file a form with the SEC.                  22 THE COURT: Okay. I think the question was whether                  23 or not Mr. Scrusby was aware of it.                  24 MR. SJOBLOM: Would you repeat the first part of                  25 that then, please?</p>	<p style="text-align: right;">Page 21</p> <p>1 Q. During the last two weeks of March 2003, did Mr. Owens                  2 tell you that his wife had concerns?                  3 MR. SJOBLOM: Objection. Instruct the witness not                  4 to answer and to assert his right against self-incrimination                  5 under the Fifth Amendment.                  6 BY MR. HICKS:                  7 Q. Did Mr. Owens tell you that his wife's concern in                  8 substance was that if he kept signing phony financial                  9 statements, he would wind up in jail or prison?                  10 MR. SJOBLOM: Objection, and instruct the witness                  11 not to answer and to assert his right against                  12 self-incrimination under the Fifth Amendment.                  13 Q. Did you tell him that his wife was right?                  14 MR. SJOBLOM: Objection, and instruct the witness                  15 not to answer and to assert his right against                  16 self-incrimination under the Fifth Amendment.                  17 Q. During the last two weeks of March 2003, did you tell Mr.                  18 Owens that from here out HealthSouth would have good                  19 numbers?                  20 MR. SJOBLOM: Objection, and instruct the witness                  21 not to answer and to assert his right against                  22 self-incrimination under the Fifth Amendment.                  23 BY MR. HICKS:                  24 Q. During the last two weeks of March 2003, did you tell Mr.                  25 Owens in substance that after the write-off last quarter</p>

<p style="text-align: right;">Page 22</p> <p>1 people think the deck is clean, or that people are saying  2 that HealthSouth has cleaned it up?  3 MR. SJOBLUM: Objection, and instruct the witness  4 not to answer and to assert his right against  5 self-incrimination.  6 Q. During the last two weeks of March 2003, did you discuss  7 the balance sheet or income statement with Mr. Owens?  8 MR. SJOBLUM: Objection, and instruct the witness  9 not to answer and to assert his right against  10 self-incrimination.  11 Q. During the last two weeks of March 2003, did you tell Mr.  12 Owens that he could fix the balance sheet by going quarter to  13 quarter?  14 MR. SJOBLUM: Objection, and instruct the witness  15 not to answer and to assert his right against  16 self-incrimination under the Fifth Amendment.  17 BY MR. HICKS:  18 Q. During the last two weeks of March 2003, did you ever  19 tell Mr. Owens that he could fix the balance sheet over time  20 for the income statement; but if there was a way to fix it  21 now, he could, but you thought he would get killed?  22 MR. SJOBLUM: Object to the form of the question,  23 first of all; it's compound. But in addition, I instruct the  24 witness not to answer and to assert his right against  25 self-incrimination under the Fifth Amendment.</p>	<p style="text-align: right;">Page 24</p> <p>1 self-incrimination under the Fifth Amendment.  2 THE COURT: I believe that I'm going to tell you  3 that I think that he has waived his right with respect to his  4 Fifth Amendment with respect to his sale and trade of  5 HealthSouth shares by virtue of filing the memorandum of law  6 in opposition to the petition for emergency freeze of the  7 assets of defendant Richard M. Scrusby, filed yesterday at  8 3:36, because on Pages 25 and 26 Mr. Scrusby discusses his  9 sale of shares, and I think he has waived his right under the  10 Fifth Amendment by filing that yesterday with the court.  11 So you must answer.  12 MR. SJOBLUM: May I have a moment, Your Honor?  13 THE COURT: Yes, sir. I thought you filed it.  14 MR. SJOBLUM: Well, I wanted to see if this is  15 statements by Mr. Scrusby --  16 THE COURT: No. It's his lawyers that talk about  17 what he has done. Talk about Scrusby's two sales of HRC  18 stock in 2002 were both approved by the general counsel of  19 HRC and HRC's board of directors prior to their execution and  20 deemed proper by independent auditors after the fact.  21 Then he talks about his first 2002 trade executed on May  22 14th, 2002, and that that was because there was an option set  23 to expire the very next day.  24 Then he talks about the second sale of stocks that  25 occurred on July 31st, 2002, and that was for the purpose of</p>
<p style="text-align: right;">Page 23</p> <p>1 BY MR. HICKS:  2 Q. Did you ever suggest during the last two weeks of March  3 2003 that Mr. Owens should go down fighting?  4 MR. SJOBLUM: Objection, and instruct the witness  5 not to answer and to assert his right against  6 self-incrimination under the Fifth Amendment.  7 Q. With regard to the filing of the Form 10-Q for the  8 quarter ending September 2002, did Mr. McVay ask you for a  9 bonus or an employment contract before he would sign the  10 certification for that 10-Q?  11 MR. SJOBLUM: Objection, and instruct the witness  12 not to answer and to assert his right against  13 self-incrimination under the Fifth Amendment.  14 Q. In fact, did he ask for a bonus of \$500,000 or more  15 before he would sign it?  16 MR. SJOBLUM: Objection, and instruct the witness  17 not to answer and to assert his right against  18 self-incrimination under the Fifth Amendment.  19 (Pause.)  20 BY MR. HICKS:  21 Q. Mr. Scrusby, are you aware of approximately or  22 specifically of the value of stock you have sold since your  23 tenure at HealthSouth?  24 MR. SJOBLUM: Objection, and instruct the witness  25 not to answer and to assert his right against</p>	<p style="text-align: right;">Page 25</p> <p>1 repaying an outstanding loan made to him on September 12th,  2 1999, and that the passing of the Sarbanes Oxley Act put  3 pressure on him to pay back the loan early.  4 So I think you've got to answer that one.  5 MR. SJOBLUM: Your Honor, I still object.  6 THE COURT: Okay. That's fine. I'm instructing the  7 witness to answer.  8 MR. SJOBLUM: Well, then, Your Honor, I think maybe  9 we need to have a Hoffman type hearing where anything -- This  10 is a legal brief filed on behalf of Mr. --  11 THE COURT: Yes, sir. But you cannot represent  12 something to the Court and then take the Fifth Amendment the  13 next day.  14 MR. SJOBLUM: No, no. These are my synthesizing of  15 facts and documents that I reviewed. That is totally  16 different than asking a witness. I cannot waive the  17 witness's Fifth Amendment right by filing any brief.  18 THE COURT: Well, I think you just did.  19 So you may answer that.  20 MR. SJOBLUM: Well, then, Your Honor, if we might,  21 I'd rather brief that issue and give you the law.  22 THE COURT: That request is denied.  23 You may answer that question, if you can remember the  24 question.  25 THE WITNESS: Maybe we should repeat it again.</p>

<p style="text-align: right;">Page 26</p> <p>1 THE COURT: I think that's a good idea.                  2 MR. SJOBLUM: Your Honor, I object. And I think                  3 perhaps with all due respect to Your Honor that I think a                  4 couple of procedural problems have arisen, one of which is                  5 he's certainly entitled to a Hoffman type hearing. And                  6 secondly, if the Court's position is that a legal brief that                  7 I filed, in which I analyzed facts, somehow results in a                  8 waiver of the witness/defendant's Fifth Amendment rights, I                  9 think that we are entitled to an immediate appeal on that                  10 issue.                  11 THE COURT: Well, sir, if you had not put in there                  12 your statements about what pressure Mr. Scrusby was under,                  13 that might be a little bit different. But we're going to                  14 proceed with this hearing at this time.                  15 Would you repeat the question, Mr. Hicks?                  16 MR. HICKS: The best I can remember it. I'll                  17 rephrase it.                  18 MR. SJOBLUM: Your Honor --                  19 THE COURT: All right. No, sir. I asked Mr. Hicks                  20 to restate his question.                  21 MR. SJOBLUM: But I think the Court --                  22 THE COURT: You may not interrupt.                  23 MR. SJOBLUM: May I make a request for the record?                  24 THE COURT: You may make an objection when the next                  25 question is asked if you wish to.</p>	<p style="text-align: right;">Page 28</p> <p>1 the documents that are inserted in that brief are board                  2 minutes, letters, that are totally different. Those are                  3 statements made by boards, compensation committee, lawyers                  4 that have approved it, board resolutions, outside lawyers,                  5 the general counsel of HealthSouth. Those are the statements                  6 I drew from in providing that evidence, and it's my                  7 interpretation to the Court. I think that is totally                  8 different than compelling this man to answer a question that                  9 could incriminate him when there is an impending criminal                  10 indictment just about ready to drop.                  11 THE COURT: You've made your statement.                  12 You may answer.                  13 MR. SJOBLUM: Your Honor, could I respectfully                  14 request that we suspend this hearing or adjourn this hearing                  15 and take this up --                  16 THE COURT: You may request that. And that request                  17 is denied.                  18 A. What's the question?                  19 Q. The question is, can you tell me in dollar amount                  20 approximately the amount of HealthSouth stock that you sold                  21 while you were employed at HealthSouth?                  22 A. I can't recall exactly.                  23 Q. Would it be in the vicinity of \$175M?                  24 A. I can't recall exactly.                  25 Q. Would it help your recollection --</p>
<p style="text-align: right;">Page 27</p> <p>1 MR. SJOBLUM: Thank you.                  2 BY MR. HICKS:                  3 Q. Did you from time to time sell HealthSouth stock during                  4 your tenure at HealthSouth, which would be at least from '86                  5 to the current time?                  6 MR. SJOBLUM: Objection, and instruct the witness                  7 not to answer and to assert his right against                  8 self-incrimination under the Fifth amendment.                  9 THE COURT: Hang on just a minute.                  10 (Reading.)                  11 He doesn't have to answer that question.                  12 MR. HICKS: I don't recall the question that you                  13 approved him answering.                  14 THE COURT: Okay. Well, it's not my job to recall                  15 it. It's your job to recall it.                  16 BY MR. HICKS:                  17 Q. All right. Can you tell me approximately the amount in                  18 dollars of HealthSouth stock that you sold while you were at                  19 HealthSouth?                  20 MR. SJOBLUM: I'd object, and instruct the witness                  21 not to answer and to assert his right against                  22 self-incrimination under the Fifth Amendment.                  23 THE COURT: Overruled.                  24 You have to answer.                  25 MR. SJOBLUM: Your Honor, may I make a point? That</p>	<p style="text-align: right;">Page 29</p> <p>1 MR. SJOBLUM: May I show him something to refresh                  2 his recollection?                  3 MR. SJOBLUM: May I see it first?                  4 THE COURT: Absolutely.                  5 MR. SJOBLUM: Can I have a representation from the                  6 SEC counsel what this document represents and where the data                  7 came from and the interpreted information on here, who made                  8 that?                  9 THE COURT: Okay. If I could have a copy of it.                  10 Okay. You want a statement from Mr. Hicks about where                  11 this document came from?                  12 MR. SJOBLUM: Right. He is involved --                  13 THE COURT: Just very simple. Is that what you want                  14 is a statement from Mr. Hicks about where this document                  15 originated?                  16 MR. SJOBLUM: A representation of what this is.                  17 THE COURT: Okay.                  18 Mr. Hicks, I think you can do that.                  19 MR. HICKS: I can do that. There is -- Actually,                  20 it's already in the record, a records custodian affidavit                  21 from HealthSouth explaining all this. The underlying --                  22 THE COURT: That's not what he asked.                  23 MR. HICKS: The underlying documents are, I think,                  24 HealthSouth business records.                  25 THE COURT: Okay.</p>

<p style="text-align: right;">Page 30</p> <p>1 MR. HICKS: And the summary is just a summary.  2 MR. SJOBLUM: It's the result of information  3 compiled from same day sale summaries. If you look in the  4 far right, someone is making an assessment or interpretation  5 of what happened and didn't happen.  6 THE COURT: Okay. Hang on just a minute.  7 (Reading.)  8 MR. HICKS: Your Honor, my colleague advises me that  9 the same day sales are also on the underlying document.  10 MR. SJOBLUM: Well, are you representing that all of  11 these are same day sales or they're not same day sales? Or  12 you don't know?  13 MR. HICKS: I'm going to ask him.  14 THE COURT: Okay. You may show the document to Mr.  15 Scrusby to see if that refreshes his recollection.  16 MR. HICKS: Thank you (complying).  17 MR. SJOBLUM: Your Honor, is the question before the  18 witness whether or not this refreshes his recollection?  19 THE COURT: Yes.  20 Q. Does that refresh your recollection?  21 MR. SJOBLUM: Your Honor, I'd renew my objection on  22 the ground --  23 THE COURT: Okay.  24 Q. You can answer.  25 A. I can't speak to the accuracy of this. There are some</p>	<p style="text-align: right;">Page 32</p> <p>1 among other things, asking to partially lift the assets  2 freeze and asking for, I think, 10 million in living  3 expenses, 30 million in legal defense costs, and another 30  4 million or so in tax payments. I can figure out the last  5 two, but can you tell me what the 10 million in living  6 expenses represents?  7 MR. SJOBLUM: Objection, and instruct the witness  8 not to answer and to assert his right against  9 self-incrimination under the Fifth Amendment.  10 MR. HICKS: May I respond to that, Your Honor?  11 THE COURT: Yes.  12 MR. HICKS: I think it's kind of absurd to file a  13 motion asking for 10 million in living expenses and then  14 refuse to say what they are.  15 THE COURT: Well, the motion is not before me today,  16 Mr. Hicks.  17 MR. HICKS: No. But it's --  18 THE COURT: Right now all I have here is your motion  19 for -- or your petition for emergency relief, freezing all of  20 the assets of Mr. Scrusby. And you object to the hearing. A  21 request by Mr. Scrusby to partially hear just the issue of  22 whether or not part of the frozen assets -- that the freeze  23 can be lifted to provide you with living expenses and tax  24 payments and attorney's fees.  25 But I would also say this: If there is no evidence on</p>
<p style="text-align: right;">Page 31</p> <p>1 things here that look inaccurate to me .  2 THE COURT: That looks?  3 THE WITNESS: Inaccurate.  4 THE COURT: Okay.  5 THE WITNESS: This is not complete, and I'm not sure  6 that it's accurate, Your Honor.  7 THE COURT: I'm sorry. You said what?  8 THE WITNESS: I said I'm not sure that this is  9 accurate. It does not look accurate to me.  10 THE COURT: The whole document?  11 THE WITNESS: It just looks incomplete.  12 THE COURT: I cannot hear you.  13 THE WITNESS: It looks incomplete.  14 THE COURT: Oh. Okay.  15 MR. SJOBLUM: So the answer is that it does not  16 refresh your recollection?  17 THE WITNESS: No, sir.  18 BY MR. HICKS:  19 Q. All right. When you say it looks incomplete, do you mean  20 there are other transactions not listed there?  21 MR. SJOBLUM: Objection, and instruct the witness  22 not to answer and to assert his right against  23 self-incrimination under the Fifth Amendment.  24 THE COURT: You don't have to answer that.  25 Q. Your counsel, I guess, filed a motion with the Court,</p>	<p style="text-align: right;">Page 33</p> <p>1 this issue with respect to living expenses, there won't be a  2 ruling with respect to living expenses.  3 MR. SJOBLUM: I would just point out, if I may, Your  4 Honor, for the record, our brief says \$10 million during the  5 pendency of these proceedings.  6 THE COURT: I read it.  7 MR. SJOBLUM: Thank you.  8 BY MR. HICKS:  9 Q. Mr. Scrusby, will you tell us what your current living  10 expenses are?  11 MR. SJOBLUM: Objection, and instruct the witness  12 not to answer and to assert his right against  13 self-incrimination under the Fifth Amendment.  14 (Pause.)  15 Q. Mr. Scrusby, how many automobiles do you currently own?  16 MR. SJOBLUM: Objection, and instruct the witness  17 not to answer and to assert his right against  18 self-incrimination under the Fifth Amendment.  19 THE COURT: Hang on just a minute.  20 (Reading.)  21 MR. SJOBLUM: Your Honor --  22 THE COURT: Hang on just a minute because I have  23 that information.  24 MR. SJOBLUM: And I also have a second objection  25 that it's irrelevant. What number of automobiles this</p>

<p style="text-align: right;">Page 34</p> <p>1 individual has is totally irrelevant to this proceeding on                  2 behalf of the SEC. It's not only irrelevant to the charges,                  3 as I suggest are in the brief, but if the SEC plans on going                  4 that route, then we would request a probable cause hearing.                  5 And they have to trace funds that they say are the product of                  6 an illegal conduct into an asset.                  7 So I have multiple objections to this question.                  8 MR. HICKS: May I respond?                  9 First of all, we don't have to trace, and there is plenty                  10 of law on that. In our case it's just enough -- It's assets                  11 to satisfy the claim, that's all. They are alleging we do                  12 have to trace. And I don't know how you make that kind of                  13 record without going into the assets.                  14 And another reason was how do his assets and the values                  15 comply with the claim -- I mean, compare with the claim? So                  16 again, that's --                  17 MR. SJOBLOM: Your Honor, if I might, and I didn't                  18 intend at this point to bring this up. I was saving it for a                  19 later date, at a later moment in this hearing. But obviously                  20 our position is not only the Eleventh Circuit but the United                  21 States Supreme Court has ruled that unless the government can                  22 show a claim, asserting an equitable claim, in a race, i.e.,                  23 these cars, and they can trace the funds from this activity                  24 into that, the Court does not have the power, the judicial                  25 power, under the Constitution to grant the type of asset</p>	<p style="text-align: right;">Page 36</p> <p>1 and I'm going to let the defendant take his Fifth Amendment                  2 right not to answer that question.                  3 MR. SJOBLOM: All right.                  4 BY MR. HICKS:                  5 Q. How many boats do you have, Mr. Scruschy?                  6 MR. SJOBLOM: I'm sorry?                  7 MR. HICKS: How many boats?                  8 MR. SJOBLOM: I would object. It's irrelevant, and                  9 I instruct him not to answer.                  10 THE COURT: If that's your only objection, your                  11 objection is overruled.                  12 MR. SJOBLOM: I would also object and instruct the                  13 witness not to answer and assert his right against                  14 self-incrimination under the Fifth Amendment.                  15 THE COURT: Okay.                  16 If he takes the Fifth Amendment, I'm not going to make                  17 him answer on this.                  18 BY MR. HICKS:                  19 Q. How many yachts do you have, Mr. Scruschy?                  20 MR. SJOBLOM: Objection. Instruct the witness not                  21 to answer and to assert his right against self-incrimination.                  22 THE COURT: Okay.                  23 BY MR. HICKS:                  24 Q. How many of your boats have captains or crews?                  25 MR. SJOBLOM: Objection, and instruct the witness</p>
<p style="text-align: right;">Page 35</p> <p>1 freeze that he's requesting.                  2 Now, I just might add, Your Honor, this is a case of                  3 first impression not only in this circuit but perhaps in the                  4 United States. But since the Grupo decision came out, it is                  5 clear to the extent, even to the extent Grupo relies on                  6 DeBeers, the U. S. Government cannot collect assets of an                  7 individual prior to a Hoffman trial, prior to judgment, and                  8 attempt to assert an equitable claim in that race without                  9 having an equitable claim, which this is not. This is                  10 clearly a claim for money damages. That's all we're talking                  11 about.                  12 THE COURT: I think, Mr. Sjoblom, that you need to                  13 look at the United States v. Oncology Associates, PC. It's a                  14 Fourth Circuit opinion cited in 198 F.3d 489, that I feel                  15 like it's right on point. It distinguishes Grupo when there                  16 is a request for more than just money damages. You do need                  17 just look at that.                  18 But this is not really the time to take this up. This                  19 right now is a question on whether or not Mr. Scruschy should                  20 answer the question about how many automobiles he owns. And                  21 you maintain that he should assert his Fifth Amendment right                  22 not to answer.                  23 MR. SJOBLOM: And it's irrelevant. It is totally                  24 irrelevant.                  25 THE COURT: Okay. I think you have made your point,</p>	<p style="text-align: right;">Page 37</p> <p>1 not to answer and to assert his right against                  2 self-incrimination under the Fifth Amendment.                  3 Q. Do you have an airplane or airplanes?                  4 MR. SJOBLOM: Objection, and instruct the witness                  5 not to answer and to assert his right against                  6 self-incrimination under the Fifth Amendment.                  7 Q. Do you have airplanes with pilots that are in your                  8 employ?                  9 MR. SJOBLOM: Objection, and instruct the witness                  10 not to answer and to assert his right against                  11 self-incrimination under the Fifth Amendment.                  12 BY MR. HICKS:                  13 Q. Is it fair to say you own approximately 40 automobiles?                  14 MR. SJOBLOM: Objection, and instruct the witness                  15 not to answer and to assert his right against                  16 self-incrimination under the Fifth Amendment.                  17 MR. HICKS: Just a minute.                  18 (Discussion off record.)                  19 BY MR. HICKS:                  20 Q. Mr. Scruschy, were you aware of any fraudulent altering of                  21 HealthSouth books and records --                  22 MR. SJOBLOM: Objection.                  23 Q. -- over the last five years?                  24 MR. SJOBLOM: Objection, and instruct the witness                  25 not to answer and to assert his right against</p>

<p style="text-align: right;">Page 38</p> <p>1 self-incrimination under the Fifth Amendment.                  2 THE COURT: Okay.                  3 Q. Did you know that HealthSouth was filing reports with the                  4 Commission -- and by that, includes Form 10-Ks, 10-Qs, 8-Ks,                  5 registration statements, or anything else -- that contained                  6 fraudulent financial statements?                  7 MR. SJOBLOM: Objection, and instruct the witness                  8 not to answer and to assert his right against                  9 self-incrimination under the Fifth Amendment.                  10 Q. Were you aware that HealthSouth's financial statements                  11 since 1997 overstated income by approximately \$2.6B?                  12 MR. SJOBLOM: Objection. Instruct the witness not                  13 to answer and to assert his right against self-incrimination                  14 under the Fifth Amendment.                  15 BY MR. HICKS:                  16 Q. Did you in fact instruct HealthSouth employees to do                  17 that?                  18 MR. SJOBLOM: Objection. Instruct the witness not                  19 to answer and to assert his right against self-incrimination                  20 under the Fifth Amendment.                  21 MR. HICKS: I have nothing further.                  22 THE COURT: Thank you, sir.                  23 MR. SJOBLOM: I have nothing, Your Honor.                  24 THE COURT: Thank you very much.                  25 You may step down, Mr. Scrushy.</p>	<p style="text-align: right;">Page 40</p> <p>1 what positions they hold or any specific information about                  2 them.                  3 THE COURT: Well, unfortunately, there is not a                  4 scheduling order in place ordering the plaintiff to notify                  5 you of who the witnesses are they plan to call. And there's                  6 not one, on the other hand, that orders you to identify to                  7 the plaintiff who you want to call. So the objection is                  8 overruled.                  9 BY MR. LOOMIS:                  10 Q. Can you tell us where you are employed?                  11 A. The Country Club of Birmingham.                  12 Q. And what is your position there?                  13 A. I work in the accounting department.                  14 Q. How long have you been employed there?                  15 A. Since May of 2002.                  16 Q. And where were you employed prior to the Country Club of                  17 Birmingham?                  18 A. HealthSouth Corporation.                  19 Q. And in what area of HealthSouth Corporation?                  20 A. The asset management department.                  21 THE COURT: The what?                  22 THE WITNESS: Asset management.                  23 Q. Were you in the asset management department for any                  24 particular region of HealthSouth?                  25 A. The Midwest region.</p>
<p style="text-align: right;">Page 39</p> <p>1 MR. HICKS: Can we keep him subject to re-call, Your                  2 Honor?                  3 THE COURT: Yes.                  4 MR. LOOMIS: Good morning, Your Honor. We would                  5 call Michael Vines to the stand. He's sitting outside the                  6 courtroom.                  7 MICHAEL VINES                  8 was sworn/affirmed and testified as follows:                  9 BY THE COURTROOM DEPUTY:                  10 Q. Would you state your full name for the record?                  11 A. Michael Vines.                  12 Q. Will you spell your last name, please?                  13 A. V-i-n-e-s.                  14 Q. The city and state where you live?                  15 A. Birmingham, Alabama.                  16 THE COURT: Good morning.                  17 THE WITNESS: Good morning.                  18 DIRECT EXAMINATION                  19 BY MR. LOOMIS:                  20 Q. Mr. Vines, where are you currently employed?                  21 MR. SJOBLOM: Your Honor, I object to the calling of                  22 this witness. We asked the Securities and Exchange                  23 Commission to identify for us who the witnesses would be that                  24 they would call at this hearing, and they declined to do                  25 that. So we have had no knowledge of who these people are or</p>	<p style="text-align: right;">Page 41</p> <p>1 MR. SJOBLOM: I'm sorry?                  2 THE WITNESS: The Midwest region.                  3 MR. SJOBLOM: Thank you.                  4 Q. Can you describe for the Court what your responsibilities                  5 were in that role?                  6 A. I was in charge of the expenses for 500 facilities,                  7 making sure equipment, purchases of new equipment for the                  8 facilities, making sure they're at the right facility and the                  9 right account.                  10 Q. Who was your immediate supervisor while you worked at                  11 HealthSouth?                  12 A. Cathy Edwards.                  13 Q. While you were employed with HealthSouth, did you ever                  14 personally witness a falsification of any documents that were                  15 to be given to Ernst &amp; Young?                  16 A. Yes.                  17 Q. Tell us about that.                  18 A. For the December 2001 audit. E&amp;Y picks two assets each                  19 year to do the depreciation test on to make sure depreciation                  20 is calculated correctly and the life is right for the life of                  21 the asset.                  22 Q. Who is E&amp;Y?                  23 A. Ernst &amp; Young.                  24 Q. Go ahead.                  25 A. Two assets were chosen. One of the assets was a true</p>

<p style="text-align: right;">Page 38</p> <p>1 self-incrimination under the Fifth Amendment.                  2 THE COURT: Okay.                  3 Q. Did you know that HealthSouth was filing reports with the                  4 Commission – and by that, includes Form 10-Ks, 10-Qs, 8-Ks,                  5 registration statements, or anything else – that contained                  6 fraudulent financial statements?                  7 MR. SJOBLOM: Objection, and instruct the witness                  8 not to answer and to assert his right against                  9 self-incrimination under the Fifth Amendment.                  10 Q. Were you aware that HealthSouth's financial statements                  11 since 1997 overstated income by approximately \$2.6B?                  12 MR. SJOBLOM: Objection. Instruct the witness not                  13 to answer and to assert his right against self-incrimination                  14 under the Fifth Amendment.                  15 BY MR. HICKS:                  16 Q. Did you in fact instruct HealthSouth employees to do                  17 that?                  18 MR. SJOBLOM: Objection. Instruct the witness not                  19 to answer and to assert his right against self-incrimination                  20 under the Fifth Amendment.                  21 MR. HICKS: I have nothing further.                  22 THE COURT: Thank you, sir.                  23 MR. SJOBLOM: I have nothing, Your Honor.                  24 THE COURT: Thank you very much.                  25 You may step down, Mr. Scrushy.</p>	<p style="text-align: right;">Page 40</p> <p>1 what positions they hold or any specific information about                  2 them.                  3 THE COURT: Well, unfortunately, there is not a                  4 scheduling order in place ordering the plaintiff to notify                  5 you of who the witnesses are they plan to call. And there's                  6 not one, on the other hand, that orders you to identify to                  7 the plaintiff who you want to call. So the objection is                  8 overruled.                  9 BY MR. LOOMIS:                  10 Q. Can you tell us where you are employed?                  11 A. The Country Club of Birmingham.                  12 Q. And what is your position there?                  13 A. I work in the accounting department.                  14 Q. How long have you been employed there?                  15 A. Since May of 2002.                  16 Q. And where were you employed prior to the Country Club of                  17 Birmingham?                  18 A. HealthSouth Corporation.                  19 Q. And in what area of HealthSouth Corporation?                  20 A. The asset management department.                  21 THE COURT: The what?                  22 THE WITNESS: Asset management.                  23 Q. Were you in the asset management department for any                  24 particular region of HealthSouth?                  25 A. The Midwest region.</p>
<p style="text-align: right;">Page 39</p> <p>1 MR. HICKS: Can we keep him subject to re-call, Your                  2 Honor?                  3 THE COURT: Yes.                  4 MR. LOOMIS: Good morning, Your Honor. We would                  5 call Michael Vines to the stand. He's sitting outside the                  6 courtroom.                  7 MICHAEL VINES                  8 was sworn/affirmed and testified as follows:                  9 BY THE COURTROOM DEPUTY:                  10 Q. Would you state your full name for the record?                  11 A. Michael Vines.                  12 Q. Will you spell your last name, please?                  13 A. V-i-n-e-s.                  14 Q. The city and state where you live?                  15 A. Birmingham, Alabama.                  16 THE COURT: Good morning.                  17 THE WITNESS: Good morning.                  18 DIRECT EXAMINATION                  19 BY MR. LOOMIS:                  20 Q. Mr. Vines, where are you currently employed?                  21 MR. SJOBLOM: Your Honor, I object to the calling of                  22 this witness. We asked the Securities and Exchange                  23 Commission to identify for us who the witnesses would be that                  24 they would call at this hearing, and they declined to do                  25 that. So we have had no knowledge of who these people are or</p>	<p style="text-align: right;">Page 41</p> <p>1 MR. SJOBLOM: I'm sorry?                  2 THE WITNESS: The Midwest region.                  3 MR. SJOBLOM: Thank you.                  4 Q. Can you describe for the Court what your responsibilities                  5 were in that role?                  6 A. I was in charge of the expenses for 500 facilities,                  7 making sure equipment, purchases of new equipment for the                  8 facilities, making sure they're at the right facility and the                  9 right account.                  10 Q. Who was your immediate supervisor while you worked at                  11 HealthSouth?                  12 A. Cathy Edwards.                  13 Q. While you were employed with HealthSouth, did you ever                  14 personally witness a falsification of any documents that were                  15 to be given to Ernst &amp; Young?                  16 A. Yes.                  17 Q. Tell us about that.                  18 A. For the December 2001 audit, E&amp;Y picks two assets each                  19 year to do the depreciation test on to make sure depreciation                  20 is calculated correctly and the life is right for the life of                  21 the asset.                  22 Q. Who is E&amp;Y?                  23 A. Ernst &amp; Young.                  24 Q. Go ahead.                  25 A. Two assets were chosen. One of the assets was a true</p>

<p style="text-align: right;">Page 42</p> <p>1 asset that was purchased by the facility.                  2 I forwarded the invoice, provided the invoice copy, to                  3 Cathy Edwards.                  4 THE COURT: Okay. Now, who is Cathy Edwards?                  5 THE WITNESS: Cathy Edwards was my immediate                  6 supervisor.                  7 THE COURT: Okay.                  8 A. The other asset that was questioned by Ernst &amp; Young was                  9 an AP summary. Cathy knew that this asset was not a real                  10 asset, and she scanned the accounts payable system to try to                  11 find a dollar amount close to what she was needing. She                  12 found a dollar amount close to what she was needing. She                  13 then wanted me to pull the invoice and give the invoice to                  14 her. And then she scanned the invoice on a scanner so she                  15 could alter the street address and the purchase amount, sales                  16 tax, and shipping to equal the amount that --                  17 THE COURT REPORTER: I'm sorry?                  18 THE COURT: Can you turn up the volume?                  19 A. She put it on the scanner so she could alter the ship-to                  20 address where the asset was questioned from, the sales tax                  21 and also the shipping cost to equal the amount that E&amp;Y was                  22 questioning. That invoice was then given to E&amp;Y.                  23 Q. Did you witness this alteration of the invoice?                  24 A. Yes.                  25 Q. Do you recall the facility at which the amount was</p>	<p style="text-align: right;">Page 44</p> <p>1 won't question the asset under that dollar amount. They                  2 start questioning \$5,000 and above.                  3 MR. LOOMIS: May I approach?                  4 THE COURT: Yes.                  5 MR. LOOMIS: I'd like to have this exhibit marked.                  6 THE COURT: My courtroom deputy.                  7 THE COURTROOM DEPUTY: (Complying.)                  8 MR. LOOMIS: Would Your Honor like a copy?                  9 THE COURT: Yes. That would be helpful.                  10 Have you given him a copy?                  11 MR. LOOMIS: Yes, ma'am.                  12 THE COURT: Okay.                  13 Do you have it, Mr. Sjoblom?                  14 MR. SJOBLOM: I do. Thank you.                  15 THE COURT: Okay.                  16 BY MR. LOOMIS:                  17 Q. Mr. Vines, can you tell me what is Exhibit 1?                  18 A. Exhibit 1 is expenses that were moved out of the minor                  19 equipment account in December of 2001. The expenses were                  20 credited out of minor and debited to the capital accounts.                  21 Q. And there is some handwriting on the left, the lower                  22 left-hand corner of the first page. Can you tell me what                  23 that is?                  24 A. That is my supervisor's signature at HealthSouth.                  25 Q. Cathy Edwards?</p>
<p style="text-align: right;">Page 43</p> <p>1 questioned by E&amp;Y, Ernst &amp; Young?                  2 A. It was a facility in Kansas, I believe. I think the name                  3 was MidAmerica.                  4 Q. And do you recall the facility for which there was an                  5 invoice found that was subsequently altered?                  6 A. It was Braintree, which is in the state of Massachusetts.                  7 Q. And do you recall while you were employed at HealthSouth                  8 any other instances in which you were asked to do something                  9 that made you feel uncomfortable or that you thought was                  10 improper?                  11 A. Yes.                  12 Q. Tell us about that.                  13 A. The same year, 2001, Cathy had set up a query to look at                  14 four expense accounts. She then came to me saying these four                  15 expense accounts we need to move out anything between \$500                  16 and \$4,999. She said move these out to the capital accounts,                  17 which is the equipment account for the facilities.                  18 Q. When you say move out, can you be a little bit more                  19 specific?                  20 A. Credit the expenses out of the expense accounts and debit                  21 the equipment account.                  22 Q. What was the impact of doing that?                  23 A. Decreasing expenses and increasing asset accounts.                  24 Q. Is there any magic number for the 4,999?                  25 A. Four Thousand Ninety-Nine (sic), Ernst &amp; Young, they</p>	<p style="text-align: right;">Page 45</p> <p>1 A. That's Cathy Edwards.                  2 Q. Do you know why her signature appears there?                  3 A. Because I told her I was uncomfortable making the entry                  4 and I wanted her signature on it before an entry would be                  5 made.                  6 Q. And there's some handwriting in the upper right-hand                  7 corner. I believe it says 173,763.16?                  8 A. That's the dollar amount that was moved out of the minor                  9 equipment account to capital accounts.                  10 MR. SJOBLOM: I apologize. Where is the number?                  11 THE COURT: On the very top right up here                  12 (indicating).                  13 MR. SJOBLOM: Okay.                  14 And what was your answer, please?                  15 THE WITNESS: That was the dollar amount that was                  16 moved out of the minor equipment accounts to the capital                  17 accounts.                  18 THE COURT: It was debited to capital accounts?                  19 THE WITNESS: Yes.                  20 MR. LOOMIS: May I approach the witness, Your                  21 Honor?                  22 THE COURT: Yes. Actually, you don't have to ask                  23 that every time.                  24 MR. LOOMIS: Thank you, Your Honor.                  25 THE COURT: Thank you.</p>

<p style="text-align: right;">Page 46</p> <p>1 BY MR. LOOMIS:  2 Q. Mr. Vines, could you tell me what is Exhibit 2?  3 A. Exhibit 2 is expenses medium moved out of public info,  4 which is another expense account at HealthSouth, and moved to  5 the capital accounts.  6 Q. Can you tell us what kind of expenses are in that public  7 info?  8 THE COURT: Would you mind?  9 Is this public information? What is info?  10 THE WITNESS: Public information is like if they  11 have temps working in the facility or something, it's them  12 paying the temp service or advertising a job opening at a  13 facility.  14 THE COURT: Okay. And you are saying that Exhibit 2  15 were expenses that were moved out of --  16 THE WITNESS: Expenses that were moved out of public  17 info to the capital accounts.  18 Q. Capital account being an asset account?  19 A. The equipment account.  20 Q. Okay.  21 And again, there is some handwriting in the lower  22 left-hand corner of the first page. What is that?  23 A. That's Cathy Edwards' signature.  24 Q. And why is her signature on this document?  25 A. Because I did not feel comfortable making the entry, so I</p>	<p style="text-align: right;">Page 48</p> <p>1 THE WITNESS: It was '02.  2 THE COURT: Okay.  3 The other document, Exhibit No. 1, says 1-22-02.  4 THE WITNESS: Yes.  5 THE COURT: And you say that's the correct date for  6 both documents?  7 THE WITNESS: Yes, that's the correct date for both  8 documents.  9 THE COURT: Okay.  10 BY MR. LOOMIS:  11 Q. Mr. Vines, can you tell us what is Exhibit 3?  12 A. Exhibit 3 is expenses being moved out of 7200, which was  13 repairs and maintenance. The amount is removed out of --  14 credited out of expense and debited to the capital accounts.  15 Q. Is there a dollar value that's reflected on here that  16 would show the total amount?  17 A. No, not on this one.  18 Q. And I notice that Ms. Edwards, her initials don't appear  19 in the lower left-hand corner. Can you explain why that is?  20 A. She just did not sign this one.  21 Q. Did you ask her to?  22 A. Yes.  23 Q. Did you have any discussions with anybody else at  24 HealthSouth about Ms. Edwards' request to move expenses out  25 of the income statement and into the balance sheet?</p>
<p style="text-align: right;">Page 47</p> <p>1 asked for her signature on the entry.  2 Q. And in the upper right-hand corner there appears a  3 number, 662,234?  4 A. That's the amount that was moved out of expenses to  5 capital.  6 THE COURT: Now, what was the date of this?  7 THE WITNESS: December 31st, 2001.  8 MR. LOOMIS: Was the Court's question when he was  9 asked to do this?  10 THE COURT: What was the date of this document? I'm  11 trying to figure out the date of this document. This date at  12 the bottom says January 22nd, '01.  13 THE WITNESS: She approved it in January of 2002 --  14 2001. I'm sorry. 2002.  15 THE COURT: Okay. Would you state that again? Are  16 you sure about the date?  17 THE WITNESS: Yes.  18 THE COURT: Okay. What year and what date did she  19 approve it?  20 THE WITNESS: January of 2002.  21 THE COURT: Do you know why it has 2001 down here?  22 I assume that's the one. Look at Exhibit No. 2. It says  23 1-22-01.  24 THE WITNESS: Yes.  25 THE COURT: But you say it was '02?</p>	<p style="text-align: right;">Page 49</p> <p>1 A. Yes, I did.  2 Q. Tell me about that.  3 A. I was a supervisor in the department along with two other  4 supervisors, and we talked about it. And we didn't feel  5 comfortable doing it, but it was just understood that it was  6 something that had been going on at HealthSouth and it had to  7 be done.  8 MR. LOOMIS: I have no further questions, Your  9 Honor.  10 THE COURT: All right.  11 Any questions?  12 MR. SJOBLOM: I do, Your Honor. May I have one  13 moment?  14 THE COURT: Yes.  15 (Discussion off record.)  16 CROSS EXAMINATION  17 BY MR. SJOBLOM:  18 Q. Mr. Vines, my name is Tom Sjoblom. I represent Mr.  19 Scrushy. Can you describe for me what your duties were at  20 HealthSouth as this asset manager?  21 A. Asset management supervisor for the Midwest region of the  22 country. We had the country broken into three regions: the  23 West, the Midwest, and the East. And I was in charge of the  24 Midwest region along with all the inpatient hospitals that  25 HealthSouth has.</p>

<p style="text-align: right;">Page 50</p> <p>1 Q. How big a region is that? How many employees did you 2 have under you? 3 A. I had three employees under me. 4 Q. And what's the size of the region? How many facilities? 5 A. About 500 facilities. 6 Q. 500 facilities? 7 A. Uh-huh. 8 Q. Are you aware that HealthSouth has about 1800 facilities? 9 A. Yes. 10 Q. So you had under your jurisdiction almost one -- a little 11 less than one-third of all the facilities of HealthSouth; is 12 that right? 13 A. Yes. 14 Q. And how many employees did you have working with you? 15 A. Three. 16 Q. Who were your reporting lines up the chain? You 17 mentioned Cathy Edwards. 18 A. Cathy Edwards. And then after Cathy Edwards, it was 19 Emery Harris. 20 THE COURT: Who? 21 THE WITNESS: Emery Harris. 22 THE COURT: Oh. Emery Harris. 23 BY MR. SJOBLOM: 24 Q. Okay. And what was Cathy Edwards' position? 25 A. She was assistant vice president of finance,</p>	<p style="text-align: right;">Page 52</p> <p>1 THE COURT: I thought you just said 10 years of 2 experience at HealthSouth? 3 THE WITNESS: No. Five years of experience at 4 HealthSouth but 10 years of accounting experience with other 5 companies I've worked with. 6 THE COURT: Okay. 1997 to when, 2002? 7 THE WITNESS: 2002. 8 THE COURT: What month? 9 THE WITNESS: May. 10 THE COURT: You may go ahead. 11 MR. SJOBLOM: Thank you, Your Honor. 12 Q. This first instance which the SEC counsel asked you 13 about, you personally observed, I guess, a fabrication of 14 some type of invoice. Is that what you were talking about? 15 A. Yes, sir. 16 Q. And you mentioned something about that Cathy Edwards 17 asked you to, or one of the topics was changing the life of 18 an asset? 19 A. No. She changed the invoice of another facility to match 20 the asset that was in question by Ernst &amp; Young. 21 Q. Can you explain that to me, please? 22 A. The asset in question -- 23 THE COURT: Just a minute. 24 (Discussion off record.) 25 Q. I think my --</p>
<p style="text-align: right;">Page 51</p> <p>1 finance/asset management. 2 Q. Okay. Emery Harris was what at that time? 3 A. He was, I believe, assistant controller. 4 Q. Are you in, if I might call it, the finance and 5 accounting part of the company? Are you over the operations 6 side? 7 A. The accounting. 8 Q. In the accounting department? 9 A. Yes. 10 Q. In the finance/accounting/audits, all that -- 11 A. Yes. 12 Q. -- that kind of function? 13 Are you an accountant? 14 A. No. 15 Q. Do you have any accounting training? 16 A. No -- Well, I've got 10 years of accounting experience 17 working at HealthSouth and other jobs. 18 THE COURT: And? 19 THE WITNESS: Other jobs I've had in the past. 20 THE COURT: Do you have a degree? 21 THE WITNESS: No. 22 THE COURT: Okay. 23 BY MR. SJOBLOM: 24 Q. So your period of tenure at HealthSouth was how long? 25 A. For five years. From April of '97 to May of 2002.</p>	<p style="text-align: right;">Page 53</p> <p>1 THE COURT: The question was whether or not he could 2 explain it to you. Is that -- Do you still want him to do 3 that? 4 MR. SJOBLOM: I would love it. Thank you very much, 5 Your Honor. 6 THE COURT: Okay. 7 A. The asset in question was not a real asset. It was a AP 8 summary asset. 9 THE COURT: Okay. What does that mean? 10 THE WITNESS: An AP summary was just an amount that 11 was put into the asset accounts. 12 THE COURT: By whom? 13 THE WITNESS: By Accounting. 14 THE COURT: For what? How do you put something in 15 there that doesn't exist? 16 THE WITNESS: Each quarter there would be additions 17 to the asset accounts, and they were called AP summaries. 18 BY MR. SJOBLOM: 19 Q. Based on what? 20 A. I don't know. 21 Q. Where did this number come from? 22 A. It was numbers that Cathy and Emery and all the other 23 executives in the finance department would come up with. 24 Q. Executives in the finance department? 25 A. Yes.</p>

<p style="text-align: right;">Page 54</p> <p>1 Q. They somehow created a number and gave it to Cathy and 2 told her to do it? 3 A. Yes. 4 THE COURT: And it was called an AP asset? 5 THE WITNESS: AP summary, yes. 6 Q. Then what does this represent, this AP summary? 7 A. That, I don't know. 8 Q. It's just a number? 9 A. It's just a number. 10 THE COURT: And you knew that that number, whatever 11 that amount, that was a dollar amount -- 12 THE WITNESS: Yes, it was a dollar amount. 13 THE COURT: And you knew that was a nonexisting? 14 THE WITNESS: It was not a real asset. 15 THE COURT: Okay. 16 So what did she ask you to do with that? 17 THE WITNESS: Well, then what she did is she could 18 tie into the accounts payable system. She could scan the 19 account payable system for a dollar amount close to what she 20 was looking for. She found a dollar amount very close to 21 what she was looking for. She then instructed me to pull 22 that invoice so she could look at the invoice. And she said, 23 "This will work." 24 BY MR. SJOBLOM: 25 Q. Okay. You said you would scan it in the account</p>	<p style="text-align: right;">Page 56</p> <p>1 don't. And I've got to be ultimately the one who understands 2 it. 3 MR. SJOBLOM: Right. I'd like to object because I 4 don't like your question. 5 THE COURT: Well, you can object all you want to. 6 I'm still going to ask it. 7 (Laughter.) 8 THE COURT: The AP summary had a certain dollar 9 amount by it? 10 THE WITNESS: Yes. 11 THE COURT: And so are you saying that Ms. Edwards 12 changed the invoice on the account payable, which had already 13 been paid by HealthSouth to whoever had furnished them the 14 product, to change it to the amount that equaled the AP 15 summary? 16 THE WITNESS: Yes, that's correct. 17 THE COURT: Okay. And then she changed the invoice 18 so it would look like the same number as the fictitious 19 number? 20 THE WITNESS: Yes. 21 THE COURT: Where did she put it? Where did she put 22 that number? 23 THE WITNESS: Just a phony invoice. She would print 24 it. She would print the invoice -- 25 THE COURT: So that it would look like the AP</p>
<p style="text-align: right;">Page 55</p> <p>1 payables? 2 A. Yes. 3 Q. You would pick an account payable -- 4 A. Well, she could scan -- 5 Q. Excuse me. Pardon me. 6 Are you talking about an account payable to a facility of 7 HealthSouth? 8 A. Yes. 9 Q. The money that was due to HealthSouth? 10 A. No. Money that had been paid out from HealthSouth for 11 purchase of equipment. 12 Q. Okay. And she would remove one of those invoices or 13 payables out of the system and substitute the AP summary -- 14 A. No. She would get a copy of that invoice, scan it so she 15 could alter the dollar amount of the invoice and print off a 16 new copy of that invoice so she could pass it on to the 17 auditors. 18 Q. So she's altering an account payable document -- 19 A. That's already been paid. 20 Q. All right. And increasing it or decreasing it to adjust 21 to this AP summary number, wherever it comes from? 22 A. Yes. 23 Q. So the AP summary number is just a total phantom, right? 24 A. Yes. 25 THE COURT: Okay. You may understand it, but I</p>	<p style="text-align: right;">Page 57</p> <p>1 summary was a true amount? 2 THE WITNESS: Yes. 3 THE COURT: I've got you. 4 BY MR. SJOBLOM: 5 Q. Now, if I understood what you were saying, I thought you 6 said there were two assets or two invoice changes, or was 7 there just one? 8 A. Just one. 9 THE COURT: Well, I thought you said there was 10 another one. 11 THE WITNESS: Well, there were two assets, but the 12 other asset that was in question was a true asset. It was an 13 invoice provided that was a true invoice for that asset. 14 Q. So the account payable is over the true asset? 15 A. Yes. 16 Q. And this AP summary is the bogus, phantom number? 17 A. Yes. 18 Q. And this AP summary, is it supposed to represent an 19 expense or is it supposed to represent income, or what is it 20 supposed to be? 21 A. That, we never knew. We just knew that the numbers just 22 popped onto the GL each quarter. 23 THE COURT: What's a GL? 24 Q. Is GL general ledger? 25 A. General ledger, yes.</p>

<p style="text-align: right;">Page 58</p> <p>1 Q. I guessed that one right.  2 All right. So you took this number, this AP summary  3 number, whatever it was, and Cathy instructed you, is that  4 correct, to alter this invoice?  5 A. No. Cathy altered the invoice.  6 Q. She altered the invoice?  7 THE COURT: Well, do you mind if I interrupt you one  8 time?  9 MR. SJOBLOM: Please.  10 THE COURT: Where did the AP summary occur?  11 THE WITNESS: On the equipment account.  12 THE COURT: On the equipment account.  13 BY MR. SJOBLOM:  14 Q. What is the equipment account?  15 A. It's the equipment account where all the assets that  16 HealthSouth has.  17 Q. Such as?  18 A. A tread mill, a treatment table, a whirlpool.  19 Q. Is that this PP&amp;E that we see in the SEC charges?  20 A. Yeah, uh-huh.  21 Q. Property, plant and equipment?  22 A. Yes.  23 Q. So this AP summary, this bogus number, somehow ties into  24 the PP&amp;E --  25 A. Yes.</p>	<p style="text-align: right;">Page 60</p> <p>1 those changes on the invoice and then -- So she falsified the  2 records, is that what you are saying?  3 A. Yes.  4 Q. Now, what exactly was your role in that process?  5 A. Providing the copy of the invoice to her.  6 Q. You gave her a copy of the invoice for her to change?  7 A. Yes.  8 Q. Any other activity?  9 A. No.  10 Q. And these sheets that the SEC has shown you, what is your  11 role in the preparation of these -- 1, 2, and 3?  12 A. These are the ones that Cathy set up for expense accounts  13 that she wanted me to move the expenses out.  14 Q. So you did participate in this thing? After she altered  15 the invoice and came up with this fabrication, you booked it  16 in -- What is this document?  17 A. No. She booked the entry. I prepared the entry for her,  18 and she booked the entry to the expense accounts and the  19 capital accounts.  20 MR. LOOMIS: Your Honor, I'd object. There are two  21 separate instances we're talking about. Falsification of an  22 invoice, that's a separate instance. He's trying to --  23 THE COURT: Would you just slow down?  24 MR. LOOMIS: Yes, ma'am.  25 THE COURT: My goodness, you are talking fast.</p>
<p style="text-align: right;">Page 59</p> <p>1 Q. -- entry?  2 THE COURT: Okay. So what you are telling me  3 happened was, just so I understand it --  4 And you feel free to object if I ask something.  5 MR. SJOBLOM: Thank you.  6 THE COURT: -- so the object of the switch was to  7 show on the equipment account as a true asset that number  8 that had previously been a bogus asset?  9 THE WITNESS: Yes, that's true.  10 THE COURT: Okay.  11 BY MR. SJOBLOM:  12 Q. And that has the effect of increasing the property, plant  13 and equipment account. Is that what you're saying?  14 A. Yes.  15 Q. And it's artificially inflated by this AP number?  16 A. Yes.  17 THE COURT: And why was it you needed to do that  18 before the audit?  19 THE WITNESS: Because the auditors on the current  20 year, they are testing two assets. They want to see a copy  21 of the invoice.  22 THE COURT: Okay.  23 THE WITNESS: So she had to provide a copy to them.  24 BY MR. SJOBLOM:  25 Q. Okay. And just so I understand the sequence. She made</p>	<p style="text-align: right;">Page 61</p> <p>1 Okay. What is it you want to object on?  2 MR. LOOMIS: He's suggesting that these documents  3 relate to the falsification of the invoice to be given to  4 Ernst &amp; Young. And I just want to clarify --  5 THE COURT: I don't believe that's what he said.  6 Mr. Sjoblom asked him what are these about.  7 MR. LOOMIS: I'm sorry, Your Honor.  8 THE COURT: Is that correct?  9 MR. SJOBLOM: That's correct. I'm just trying to  10 understand what we're talking about.  11 THE COURT: All right.  12 MR. SJOBLOM: Your Honor, may I have a moment to get  13 some exhibits?  14 (Pause.)  15 MR. SJOBLOM: With the Court's approval, we put some  16 exhibits -- I don't know where we're going in this. But  17 rather than me handing him one exhibit at a time, if I might  18 just hand him the book. I think this is what we're talking  19 about.  20 (Pause.)  21 Q. Mr. Vines, is that correct?  22 A. Yes.  23 Q. Would you look at Tab 4, please, Page 2? Well, let's  24 take you to Tab 5 first, Page 6. Tab 5, there is a document  25 in there called "Pulling the Wagon, Integrity in Action,</p>

<p style="text-align: right;">Page 62</p> <p>1 Standards of Business Conduct." Go to Page 6 to see the 2 middle of that page something called the compliance hot 3 line. 4 THE COURT: You are talking about HRC 9683? 5 MR. SJOBLUM: Correct. That's down at the bottom. 6 BY MR. SJOBLUM: 7 Q. HRC 009683. Do you see that number? 8 A. Yes, sir. 9 Q. Are you familiar with a 1-800 hot line program at 10 HealthSouth? 11 A. Yes. 12 Q. Were you trained in that program? 13 A. No. 14 Q. You weren't? You've never had a card? 15 A. Yes. They passed out cards to us. 16 Q. You had a card. You knew what that card was? 17 A. Yes. 18 Q: What were you supposed to do with that card? 19 A. Report any activity that we were not comfortable with. 20 Q. Was there any question in your mind about what this 1-800 21 fraud program was all about? 22 A. I knew what it was about. 23 Q. You knew what it was about? 24 A. Yes, sir. 25 Q. Okay.</p>	<p style="text-align: right;">Page 64</p> <p>1 You knew that, didn't you? 2 A. Yes. 3 Q. And you knew that was fraud? 4 A. Yes. 5 Q. And you never reported it? 6 A. No. 7 Q. And you kept doing it? 8 A. I didn't put the numbers in the accounts. 9 Q. You handed invoices to Ernst &amp; Young, and you never said 10 anything to anybody? 11 A. I never handed invoices to Ernst &amp; Young. 12 Q. Well, what did you do? Tell me exactly what you did. 13 A. I provided copies of invoices to Cathy Edwards. Cathy 14 then in turn would turn the invoices over. 15 Q. All right. You knew that those invoices had been 16 fabricated; is that right? 17 A. Yes. 18 Q. And you allowed it to continue; right? 19 A. I couldn't stop it. 20 Q. You couldn't? 21 A. I couldn't stop it. 22 Q. Why couldn't you call this hot line and report it? 23 A. I guess I could have. 24 Q. Why didn't you do it? 25 A. I don't know.</p>
<p style="text-align: right;">Page 63</p> <p>1 Now, let me understand you. Cathy Edwards tells you to 2 be involved in this process of falsifying invoices and giving 3 to the outside auditor a fabricated invoice, and you never 4 reported that pursuant to that hot line; is that correct? 5 A. Did not. 6 Q. Why not? 7 A. I was not comfortable reporting at the time because I 8 didn't know -- did not know what would happen to me at 9 HealthSouth. 10 Q. I'm sorry? 11 A. I didn't know what would happen to me if I did report it. 12 Q. Do you realize, Mr. Vines, that if people like you would 13 have reported this at the moment, this would have never 14 happened? Did that ever occur to you? 15 A. No, it did not. 16 Q. How long did you do this for? 17 A. Work at HealthSouth? 18 Q. With this fabrication of the AP summary. 19 A. That happened in 2001, and I left in May of 2002. 20 Q. Okay. But this got reflected -- If I understand the SEC 21 charges, this is reflected in the 2001 10-K filed with the 22 government; is that right? 23 A. Yes. 24 Q. You knew that the numbers you put in there were going to 25 be reflected in that property, plant and equipment account?</p>	<p style="text-align: right;">Page 65</p> <p>1 Q. So you, Mr. Vines, are one reason why we are standing in 2 this courtroom and this company, which is a global company, 3 1800 facilities impacting 51,000 employees across the United 4 States, a hospital down here on Route 280 that's come to a 5 stop, eight criminal indictments and all this other stuff and 6 dragging Mr. Scrushy into this courtroom because you didn't 7 know what to do about this and you decided you wouldn't 8 report that to the hot line; is that what you're telling us? 9 MR. LOOMIS: I object. Argumentative. 10 THE COURT: Sustained. Don't answer that. 11 BY MR. SJOBLUM: 12 Q. Did you tell Ernst &amp; Young what was going on? 13 A. No, I did not. 14 Q. Do you understand what the purpose of an outside auditor 15 is? 16 A. Yes. 17 Q. What do they do? 18 A. They audit the books to make sure the company is abiding 19 by the rules of accounting. 20 Q. And if I understand your testimony, your testimony is you 21 picked numbers below the \$5,000 amount so that it would 22 escape the radar screen of Ernst &amp; Young; is that correct? 23 A. Cathy instructed me to do that. 24 Q. Oh. And you just carried it out? 25 A. I was just told what to do by my supervisor.</p>

<p style="text-align: right;">Page 66</p> <p>1 Q. You were a good soldier, huh? Is that what you're 2 saying? 3 A. I was just doing my job. 4 Q. Doing your job by engaging in fraud and lying to the 5 outside auditors. That was doing your job? 6 MR. LOOMIS: Again, object, Your Honor. 7 Argumentative. 8 THE COURT: Sustained. 9 BY MR. SJOBLOM: 10 Q. Are you aware that in corporations in the United States 11 that there is a concern, and has been a concern, about 12 corporate integrity and codes of ethics and everything that's 13 been going on in the United States for the last two years? 14 Are you aware of that? 15 A. Yes, I am. 16 Q. So at the time that the news is swirling around you, 17 Enron and all these things, you in fact are engaged in it 18 yourself; right? 19 A. I did not engage in it. I was just doing what I was 20 instructed to do. 21 Q. But you knew that there was a specific program set up to 22 report fraud within the company. You knew that, didn't you? 23 A. Yes. 24 Q. You elected not to do that; right? 25 A. Yes.</p>	<p style="text-align: right;">Page 68</p> <p>1 you see that? 2 A. Yes. 3 Q. Who put that number on there? 4 A. I wrote that number on there. 5 Q. So you knew what the effect was of engaging in this 6 process with Cathy Edwards; correct? 7 A. No. Cathy needed a certain dollar amount, and she needed 8 me to give her a total of each account that was being moved 9 out. 10 Q. Is this the number at the top of the page the phantom 11 amount that ends up going into the property, plant and 12 equipment account? 13 A. No. This is totally different. 14 Q. What is this number? 15 A. This is expenses being moved out. These are true 16 expenses that the facility had. 17 Q. Could you slow down a little bit? These are expenses -- 18 A. These are true expenses that HealthSouth did incur that 19 are moved out of expense accounts to capital accounts. 20 Q. So this is the AP summary number? 21 A. No, it's not. 22 Q. How do you distinguish this from the AP summary? 23 A. The AP summary was not a true asset. These right here 24 could be considered true assets. They were expenses incurred 25 by HealthSouth.</p>
<p style="text-align: right;">Page 67</p> <p>1 Q. And you also permitted Ernst &amp; Young, the outside 2 auditors, to be duped in not knowing what was going on so 3 they couldn't detect it as part of the audit process; right? 4 A. That's correct. 5 (Discussion off record.) 6 BY MR. SJOBLOM: 7 Q. Now, to correct the errors I may have made and Mr. Loomis 8 has objected to -- Well, let me before I get to that. 9 Again, if you look at the tops of these exhibits, Exhibit 10 1 -- 11 THE COURT: Can you also speak up? 12 MR. SJOBLOM: I'm sorry, Your Honor. 13 Should I raise this? 14 THE COURT: I don't believe you can raise it. You 15 can pick it up and take it into your hand, but I don't think 16 that would be very comfortable. Just speak up. 17 MR. SJOBLOM: I'm sweet, but not -- 18 Q. If I might, Mr. Vines, if you look at the numbers at the 19 top of this document -- 20 THE COURT: Are you looking at Exhibit 1? 21 Q. I'm looking at Exhibit 1 and Exhibit 2. 22 THE COURT: Do you have those? 23 THE WITNESS: Yes. 24 Q. Do you have those? 25 The dollar amount at the top of Exhibit 1, \$173,763, do</p>	<p style="text-align: right;">Page 69</p> <p>1 Q. What happens with this number? I think you said it got 2 moved out. 3 A. It got moved out of the expense accounts to the capital 4 accounts. 5 THE COURT: And then how did they show up on the 6 capital accounts? 7 THE WITNESS: They showed up as an asset on the 8 asset listings. 9 Q. Which capital account? 10 A. Equipment account. 11 Q. So property, plant and equipment all is reflected there? 12 THE COURT: All of them? 13 THE WITNESS: Yes, ma'am. 14 Q. On Exhibit 2, \$662,000, that's the amount, again? 15 A. Yes. 16 Q. All right. And that's your handwriting? 17 A. Yes, it is. 18 Q. Now, I'm a little bit confused on the date, the dialogue 19 that you had with the judge. Are you saying that even though 20 this is dated 1-22-01, this is really supposed to be January 21 22, '02? 22 A. Yes. 23 THE COURT: Could you please refer to the exhibit 24 number? 25 MR. SJOBLOM: Sure.</p>

<p style="text-align: right;">Page 70</p> <p>1 Q. I'm referring to Exhibit 2 and Exhibit 1 that Your Honor 2 asked you about during your direct testimony. Do you see 3 that? 4 A. Yes. 5 Q. And this has on here January 22, '01. Do you see that? 6 THE COURT: Exhibit No. 2? 7 A. Yes. 8 Q. Yeah. Also, Exhibit -- Oh. I see. 9 THE COURT: No. Exhibit No. 1 has 1-22-02. 10 MR. SJOBLOM: That's correct. 11 Q. So Exhibit No. 2, 1-22-01, is supposed to be '02. Is 12 that what you mean? 13 A. Yes. 14 Q. So both of these documents, Exhibit 1 and Exhibit 2, in 15 the amount of, if I can calculate, \$850,000 -- 16 A. Yes. 17 Q. -- is an artificial impact to overinflate the property, 18 plant and equipment account; is that right? 19 A. That's correct. 20 Q. And you knew that? 21 A. But these are true expenses though that were moved. 22 Q. That is ultimately reflected in property, plant and 23 equipment in the AP summary number, isn't it? 24 A. No. These numbers are totally different from AP summary. 25 MR. SJOBLOM: Do you understand all this?</p>	<p style="text-align: right;">Page 72</p> <p>1 Q. Now, on this one, I don't see a signature by Cathy 2 Edwards. 3 THE COURT: On Exhibit 3? 4 MR. SJOBLOM: On Exhibit 3, yes. Thank you. 5 A. She -- She was to check this upload first before it was 6 sent up. 7 Q. Was it sent up, was the dollar amount sent up? 8 A. Yes, it was. 9 Q. What was the total dollar amount? 10 A. I don't recall the dollar amount. 11 Q. Was it over \$500,000? 12 A. Yeah, I'm sure. 13 Q. Over a million dollars? 14 A. That, I don't know. 15 Q. Okay. But you delivered that number to whomever? 16 A. I gave it to Cathy Edwards. 17 Q. You gave it to Cathy Edwards. 18 THE COURT: Let me ask you something. Did she tell 19 you what figures she needed? 20 THE WITNESS: She just said that she was needing to 21 move some expenses out and she wanted expenses moved out of 22 the following accounts. 23 THE COURT: Well, how did you know how much to move 24 out? 25 THE WITNESS: After I finished with it, I would give</p>
<p style="text-align: right;">Page 71</p> <p>1 THE COURT: Yes. 2 MR. SJOBLOM: Okay. All right. 3 BY MR. SJOBLOM: 4 Q. Now, the purpose of Exhibit 3 is, I guess, according to 5 my notes, Exhibit 1 is the equipment account, right? 6 A. Yes. They are all equipment accounts. 7 Q. Okay. And Exhibit 3 is also an equipment account? 8 A. Yes. 9 Q. What is the total impact of this number -- 10 THE COURT: Let me tell you something. The first 11 Exhibit, No. 1, were expenses moved from out of the public 12 information account into a debit into a capital account, 13 which was that equipment account. 2 was expenses moved out 14 of the minor equipment account, moved to the capital 15 account. And No. 3 was expenses moved out of the 7200; 16 right? 17 THE WITNESS: 7200. 18 THE COURT: Right. 19 BY MR. SJOBLOM: 20 Q. What is the 7200 account? 21 THE COURT: That was the equipment and repair 22 account, right? 23 THE WITNESS: Repairs and maintenance. 24 THE COURT: Maintenance. Okay. 25 BY MR. SJOBLOM:</p>	<p style="text-align: right;">Page 73</p> <p>1 it to her. And she would total it up and see if that was 2 what she needed. 3 THE COURT: And if it wasn't, did she tell you to go 4 back and move some more? 5 THE WITNESS: Or she would instruct other people in 6 the department to move more expenses out. 7 THE COURT: Okay. 8 BY MR. SJOBLOM: 9 Q. Now, if I understand the lines of reporting within the 10 company, you are engaged in this with Cathy Edwards, and that 11 number is then given to Emery Harris; is that correct? Is 12 that how it goes? 13 A. Yes. 14 Q. And you're in the finance/accounting side of the 15 corporation? 16 A. Yes. 17 Q. Now, Mr. Loomis asked you about discussions with others 18 at HealthSouth about moving dollars out of income 19 accounting -- 20 A. Yes. 21 Q. -- into the balance sheet. Do you recall that? 22 A. Yes. 23 Q. Tell me again who those people were you discussed it 24 with. 25 A. They were supervisors just like I were. They were Amy</p>

<p style="text-align: right;">Page 74</p> <p>1 Watts and Wendy Walker.  2 Q. Who are they?  3 A. They are supervisors also in asset management.  4 THE COURT: Amy who?  5 THE WITNESS: Watts.  6 THE COURT: Watts. And did you mention another  7 lady?  8 THE WITNESS: Wendy Walker.  9 Q. And are they also in the Midwest?  10 A. Amy is in charge of the East and Wendy is in charge of  11 the West.  12 Q. How many facilities is that?  13 A. Makes up the difference of the 500 I had. So I think Amy  14 probably had 600 and Wendy had the remaining balance.  15 Q. So that's all the 1800 facilities for HealthSouth?  16 A. Yes.  17 Q. So the three of you accounted for all 1800 facilities  18 within HealthSouth?  19 A. Yes.  20 Q. And did Amy Watts say that this same type of activity was  21 happening under her area of supervision?  22 A. Yes.  23 Q. And Amy is, you said, the East?  24 A. The East.  25 Q. And Wendy is the West?</p>	<p style="text-align: right;">Page 76</p> <p>1 Q. Did you talk amongst the three of you whether or not  2 Ernst &amp; Young should be informed of what was going on?  3 A. No, we did not.  4 Q. Never once came up in the conversation of why do we do  5 this to Ernst &amp; Young?  6 A. No.  7 Q. Were you aware that Ernst &amp; Young publicly certified  8 filings with the SEC an audit report for the 2001 10-K that  9 the numbers were fine and reported that to the board and to  10 Mr. Scrusby? Are you aware of that?  11 A. Yes.  12 Q. You are aware of reporting obligations of a public  13 company in the United States?  14 A. Yes.  15 Q. And auditors are a part of the process?  16 A. Yes.  17 Q. And you engaged in a process to totally dupe Ernst &amp;  18 Young so they couldn't carry out their functions; correct?  19 A. I was just doing what I was instructed to do.  20 Q. And you did it at such a level, you guys were so smart,  21 you could figure out how to bring it below the \$5,000 level  22 and carry out this scheme; right?  23 A. That was the amount that Ernst &amp; Young would not look at  24 it, if it was under 5,000.  25 Q. You figured that out; right?</p>
<p style="text-align: right;">Page 75</p> <p>1 A. West.  2 Q. Okay. And Wendy Walker said the same kind of thing was  3 happening in her office?  4 A. Yes.  5 Q. People were doing the same kind of things you were doing?  6 A. Yes.  7 Q. For all 1800?  8 A. Well, I don't know for all 1800 facilities, but it was  9 happening in their regions.  10 Q. Did you discuss amongst the three of you what the total  11 dollar impact was of engaging in this process?  12 A. No.  13 Q. Never had a conversation such as --  14 A. We just --  15 Q. Pardon me?  16 A. The only thing we talked about was we weren't comfortable  17 making the entries.  18 Q. Did Amy Watts say that she was going to report it to the  19 hot line?  20 A. Not that I'm aware of.  21 Q. How about Wendy Walker, did she say she was going to  22 report it to the hot line?  23 A. Not that I'm aware of.  24 Q. Did you suggest that they report it to the hot line?  25 A. No, I did not.</p>	<p style="text-align: right;">Page 77</p> <p>1 A. I didn't figure it out. I was told that.  2 Q. You participated in intentionally deceiving the outside  3 auditors; correct?  4 A. No.  5 Q. Oh no? Why not?  6 A. Because I was just doing what I was instructed to do.  7 Q. Do you always do what you are told to do?  8 A. Yes.  9 Q. You were told to report to the hot line, weren't you?  10 A. Yes.  11 Q. Why didn't you do that?  12 A. Because I was in fear of what would happen to me in my  13 job at HealthSouth.  14 Q. And what was that, lose your compensation?  15 A. Yes.  16 Q. How much were you being paid?  17 A. I do not recall.  18 Q. How much were you being paid for the year at  19 HealthSouth? What was your income?  20 A. 38 or 39,000.  21 Q. 38 or 39,000. You are fearful of losing, but you're  22 prepared to put 52,000 people out of work and everything  23 that's been done to this corporation. Is that what you're  24 saying?  25 MR. LOOMIS: Objection.</p>

<p style="text-align: right;">Page 78</p> <p>1 THE COURT: Sustained. Don't answer.  2 Q. Did you ever tell Mr. Scrusy this was going on?  3 A. No. I never had conversations with Mr. Scrusy.  4 Q. In your whole life?  5 A. No, never have.  6 Q. Did you ever say to someone, gee, we should tell Mr.  7 Scrusy what's going on; he's the chairman of this company?  8 Did that ever occur to you?  9 A. No.  10 Q. Are you aware that he instituted and created the 1-800  11 hot line program; that was his idea to stop exactly what was  12 going on in this case, are you aware of that?  13 A. No, I'm not.  14 Q. Were you ever told that?  15 A. No.  16 MR. SJOBLOM: May I have a moment, Your Honor?  17 THE COURT: Yes.  18 (Pause.)  19 Q. Just a few more questions, Mr. Vines.  20 Are you aware of other people that Cathy Edwards might  21 have included in this scheme in addition to yourself?  22 A. Yes.  23 Q. Who were they?  24 A. Amy Watts and Wendy Walker.  25 Q. Anybody else beyond those two?</p>	<p style="text-align: right;">Page 80</p> <p>1 THE COURT: Just let him look at it. I think --  2 MR. SJOBLOM: Pardon me?  3 THE COURT: Mr. Loomis, have you looked at it?  4 MR. LOOMIS: Yes, ma'am.  5 THE COURT: All right. Go ahead.  6 MR. LOOMIS: Could we have copies of those?  7 MR. SJOBLOM: You'll get copies of them.  8 BY MR. SJOBLOM:  9 Q. (Handing document to the witness and to the Court.)  10 THE COURT: Well, while they are looking at all of  11 that, let me ask you a couple of questions.  12 Do you still have that Exhibit 5, Page 6, in front of you  13 in that notebook?  14 THE WITNESS: Yes.  15 THE COURT: Had you read that compliance top line --  16 page?  17 THE WITNESS: Yes.  18 THE COURT: Did you know that that recommended that  19 you talk to your supervisor about the wrongdoing first?  20 THE WITNESS: Yes.  21 THE COURT: And who was your supervisor?  22 THE WITNESS: Cathy Edwards.  23 THE COURT: And did you talk to her about it?  24 THE WITNESS: I told Cathy I was uncomfortable in  25 making the type of entries we were making. And she said they</p>
<p style="text-align: right;">Page 79</p> <p>1 A. No. Just those two.  2 Q. Did Amy Watts or Wendy Walker ever say to you there are  3 other people that are involved in this scheme?  4 A. No.  5 Q. Did they also report to Cathy Edwards?  6 A. Yes, they did.  7 Q. So Cathy Edwards is sitting over here as a kind of  8 mid-level supervisor, is that what she was?  9 A. Yes.  10 Q. What was your official title?  11 A. It was an asset management supervisor.  12 Q. You were a senior VP or a group VP?  13 A. No, I was not that.  14 Q. You were lower than that?  15 A. Yes.  16 Q. So all of this then, if I understand it, is taking place  17 kind of at the bottom levels of the corporation; is that  18 right?  19 A. That's correct.  20 MR. SJOBLOM: Your Honor, I have a chart, if I  21 might. Could I pull this up?  22 MR. LOOMIS: Could I see that?  23 MR. SJOBLOM: We've got copies of the --  24 THE COURT: Well, show it to him, Mr. Sjoblom.  25 MR. SJOBLOM: I have also paper sizes.</p>	<p style="text-align: right;">Page 81</p> <p>1 need to be made. And that's when I would ask for her  2 signature.  3 THE COURT: Okay.  4 All right.  5 BY MR. SJOBLOM:  6 Q. Along the same lines. Can you hear me over here? Has  7 the government talked to you about your conduct in this  8 case?  9 THE COURT: Okay. You've got to talk about people  10 here. Government?  11 Q. The Securities and Exchange Commission or the United  12 States attorney's office, have they talked to you about your  13 conduct in this case?  14 A. Well, I have provided information to what I knew was  15 going on at HealthSouth.  16 Q. Have they told you whether or not there is going to be a  17 criminal information filed against you or an indictment?  18 A. No.  19 Q. Do you have an arrangement with them that if you come  20 here and testify on behalf of the SEC, you will not be  21 charged with criminal conduct?  22 A. I was told that my information was just being brought  23 forth, that no charges would be brought against me.  24 Q. Would not be?  25 A. Yeah.</p>

<p style="text-align: right;">Page 82</p> <p>1 Q. So you have a deal with the government that if you 2 testify here today against Mr. Scrusby, you will not be 3 criminally charged, is that it? 4 A. That's the way I understand it. 5 Q. Who do you have that arrangement with, the SEC? 6 A. I've spoken to Graham, Mr. Loomis. 7 Q. Do you have that agreement with the U. S. attorney's 8 office as well? 9 A. No. 10 Q. So they are telling you that that's the deal? 11 A. Yes. 12 Q. Let me show you -- Can you see that all right? 13 A. Uh-huh. 14 Q. This is Chart No. 3. Let me just represent to the Court 15 this is for demonstrative purposes. But I think in our book 16 we've got it under Tab 2, the sheet of paper that says 17 demonstrative. So this would be our next exhibit, No. 2. So 18 this would be 2-3, if you want to call it that. 19 If I understand your -- Well, let me just tell you what 20 this is. 21 This is the entire corporate structure, if you will, of 22 HealthSouth, including on the operations side. 23 THE COURT: You can't testify. Okay? You can ask 24 him what it is. And if he knows, he can answer. But you 25 cannot testify. You are not under oath.</p>	<p style="text-align: right;">Page 84</p> <p>1 MR. LOOMIS: I'm sorry, Your Honor. 2 THE COURT: Do you want to make an objection? 3 MR. LOOMIS: I object. Lack of foundation, Your 4 Honor. 5 THE COURT: Well, he said he was familiar with the 6 administrative setup. 7 MR. LOOMIS: Okay. 8 THE COURT: Now, the question was whether or not the 9 regional VP, also known as vice president, was supervisor of 10 the administrators shown below. 11 THE WITNESS: Yes. 12 THE COURT: And you do know that from personal 13 knowledge? 14 THE WITNESS: The administrator in charge of the 15 facility and the administrator reports to the regional VP -- 16 THE COURT: The administrator is in charge of the 17 facility -- 18 THE WITNESS: The facility. The regional VP 19 reports, you know, gets information from the administrator at 20 the facility. 21 THE COURT: Okay. Now, let me ask you something 22 because you said you were in charge of the inpatient 23 hospitals? 24 THE WITNESS: Yes. 25 THE COURT: Just in your division?</p>
<p style="text-align: right;">Page 83</p> <p>1 MR. SJOBLOM: Okay. 2 Q. Now, are you aware that if 1800 facilities we're talking 3 about is what's reflected in this chart -- 4 A. Yes. 5 Q. -- do you understand the operations side of the 6 HealthSouth business? 7 A. Yes. 8 Q. Okay. Does this accurately reflect it? And the "ADM" by 9 this, I mean the administrator over -- it could be 200 10 hospitals or 300, whatever it is -- 11 A. Uh-huh. 12 Q. You have a certain number of administrators. I think 13 it's 1200 over 1800 facilities; is that correct? 14 A. That's correct. 15 Q. Okay. And as we come up the line, we have a regional VP, 16 vice president, over those administrators; correct? Is that 17 correct? 18 A. (Inaudible.) 19 THE COURT: Hold it just a minute and let him 20 answer. 21 MR. SJOBLOM: Sure. 22 MR. LOOMIS: Judge, is he testifying based on what 23 he's seeing there or does he have personal knowledge of this? 24 I think that's kind of relevant for a foundational basis -- 25 THE COURT: Okay. Don't make comments.</p>	<p style="text-align: right;">Page 85</p> <p>1 THE WITNESS: Yes. The inpatient division. 2 THE COURT: Not just in your Midwest region? 3 THE WITNESS: Yes. Not only did I have the Midwest 4 region, I also had all the inpatient hospitals. 5 THE COURT: All for the whole HealthSouth? 6 THE WITNESS: Yes, for all of them. 7 THE COURT: Okay. How many inpatient hospitals are 8 we talking about? 9 THE WITNESS: 150, 160. 10 THE COURT: So where would you fit down there on 11 that chart? 12 THE WITNESS: I would not be on this chart at all. 13 THE COURT: I didn't think so, because you would be 14 a little bit of everything on that lower part, right? 15 THE WITNESS: No. I wouldn't be on that chart at 16 all. 17 THE COURT: Okay. 18 BY MR. SJOBLOM: 19 Q. Okay. Then after the regional VP, and that's followed by 20 the group vice president. Are you aware of that? 21 A. Yes. 22 Q. Okay. And then group vice president would report to the 23 senior vice president. Are you aware of that? 24 A. Yes. 25 Q. And they in turn report to one of the three division</p>

<p style="text-align: right;">Page 86</p> <p>1 presidents; is that correct?                  2 A. That's correct.                  3 Q. All right. So the operations side of HealthSouth is                  4 divided up into three divisions each with their own                  5 president. Are you aware of that?                  6 A. Yes.                  7 Q. And on the operations side, which of the three you would                  8 fit within?                  9 A. I would fit under all three because in the Midwest region                  10 I would have inpatient hospitals, also outpatient diagnostic                  11 centers and also surgery centers.                  12 Q. Okay. So just keep this in the back of your mind. This                  13 is the operations side. Now, let me show you what I think                  14 you said is your more specific function.                  15 Now, you said you were part of the finance --                  16 A. Yes, that's correct.                  17 Q. -- departments or department of the company?                  18 Okay. And you are aware that the --                  19 THE COURT: Okay. Wait just a minute. Would you                  20 identify for the record? This is Exhibit No. 2-2.                  21 MR. SJOBLOM: Exhibit No. 2-2.                  22 THE COURT: Okay.                  23 Q. Are you aware, Mr. Vines, that the finance and accounting                  24 department also has different directorships under it?                  25 A. Yes.</p>	<p style="text-align: right;">Page 88</p> <p>1 Cathy Edwards?                  2 A. Yes.                  3 Q. And she reports to Emery Harris?                  4 A. Emery Harris.                  5 Q. Chief financial officer?                  6 A. Yes. Well, he was not chief financial officer. He was                  7 assistant controller.                  8 Q. I'm sorry. Assistant controller. Then the controller                  9 and then the chief financial. The numbers that you were                  10 dealing with and the AP summaries -- Let us put it this way.                  11 The artificial inflation of the PP&amp;E account is reported up                  12 out of your office to the assistant controller, the                  13 controller, ultimately the chief financial officer, correct?                  14 A. Yes.                  15 Q. Who is the assistant controller during your tenure?                  16 A. Emery Harris.                  17 Q. Did you ever discuss what was going on with Ms. Edwards                  18 requests of you during that time period?                  19 A. No, I did not.                  20 THE COURT: With Mr. Harris, you mean?                  21 Q. With Mr. Harris.                  22 A. No, I did not.                  23 Q. And the controller was whom?                  24 A. I can't recall who the controller was at the time.                  25 Q. Did you ever talk to the controller, whoever he was,</p>
<p style="text-align: right;">Page 87</p> <p>1 Q. All right. Including a director of internal audit;                  2 correct?                  3 A. Yes.                  4 Q. Director of reimbursement?                  5 A. That's correct.                  6 Q. Chief financial officer?                  7 A. Yes.                  8 Q. Treasurer?                  9 A. Yes.                  10 Q. Director of tax?                  11 A. Yes.                  12 Q. And under the chief financial officer you have supervisor                  13 account payables and AP clerks. Are you aware of that?                  14 A. That's correct.                  15 Q. And you also have under chief financial officer general                  16 accounting people of about a hundred employees; is that                  17 correct?                  18 A. That's correct.                  19 Q. Can you tell me where in this chart, that is, Exhibit 2-2                  20 you functioned?                  21 A. General accounting.                  22 Q. Down on the right side, down here multi-100 people; is                  23 that right?                  24 A. That's correct.                  25 Q. Okay. So your line of communication and reporting is</p>	<p style="text-align: right;">Page 89</p> <p>1 about what was going on?                  2 A. No, I did not.                  3 Q. Did you ever report this to the chief financial officer?                  4 A. No, I did not.                  5 Q. Now, this accounts payable part of Exhibit 2-2, is what                  6 you're talking about, have anything to do with the accounts                  7 payable department side over here?                  8 A. No, it did not.                  9 Q. So this is all occurring within the general accounting                  10 staff at HealthSouth?                  11 A. As far as I know.                  12 MR. SJOBLOM: Your Honor, we would move the                  13 admission of Exhibits, I think I showed Mr. Vines, 2-2 and                  14 2-3. Well, actually why don't we just take care of this.                  15 Q. To put this in perspective, this is the demonstrative                  16 Exhibit 2-1, the operations and finance, which we've been                  17 talking about, the two halves of the company.                  18 THE COURT: Sir, you may not testify. You may ask                  19 him what Exhibit No. 1 reflects. But please don't testify                  20 what it is. Thank you, sir.                  21 Q. Do you know what Exhibit No. 1 reflects, having looked at                  22 the other exhibits?                  23 A. Yes.                  24 Q. And what does it reflect?                  25 A. The operations of HealthSouth.</p>

<p style="text-align: right;">Page 90</p> <p>1 Q. And the finance side as well?</p> <p>2 A. The finance and the operations.</p> <p>3 Q. And you are on the finance and accounting side of the</p> <p>4 company?</p> <p>5 A. That's correct.</p> <p>6 Q. And your job, if I can put it what way, is to interface</p> <p>7 with operations?</p> <p>8 A. Yes.</p> <p>9 THE COURT: Were you not on the operation side too</p> <p>10 with respect to the inpatient?</p> <p>11 THE WITNESS: No.</p> <p>12 THE COURT: Okay.</p> <p>13 Q. Just to get the relationship here, is the operations side</p> <p>14 providing the finance department and accounts payable, is</p> <p>15 that where it's coming from?</p> <p>16 A. Not that I'm aware of.</p> <p>17 Q. Okay. Your best recollection is that this accounts</p> <p>18 payable originates in the finance department?</p> <p>19 A. Yes.</p> <p>20 Q. And all of this fabrication is occurring within the</p> <p>21 finance department?</p> <p>22 A. As far as I know.</p> <p>23 Q. All right.</p> <p>24 MR. SJOBLOM: All right. We move for the admission</p> <p>25 of Exhibits 2-1, 2-2 and 2-3.</p>	<p style="text-align: right;">Page 92</p> <p>1 up --</p> <p>2 MR. SJOBLOM: I might as well.</p> <p>3 THE COURT: Okay.</p> <p>4 BY MR. SJOBLOM:</p> <p>5 Q. If I could, Mr. Vines, would you please turn to Page 4?</p> <p>6 A. (Witness complying.)</p> <p>7 Q. Do you recognize what Exhibit 2-4 reflects?</p> <p>8 A. Yes.</p> <p>9 Q. Okay. What does it reflect?</p> <p>10 A. The presidents of the three operations at HealthSouth:</p> <p>11 the chief financial officer, the controller, and the</p> <p>12 accounting staff.</p> <p>13 Q. Okay. Did you mean the accounting side of the company,</p> <p>14 the accounting staff, the numbers you generate, including</p> <p>15 this artificial inflation of PP&amp;E, makes its way when the</p> <p>16 financial statements are prepared up to the president/chief</p> <p>17 operating officer?</p> <p>18 A. Yes. I understand that.</p> <p>19 Q. And that ends up in a consolidated financial statement</p> <p>20 reflecting the three divisions?</p> <p>21 A. Yes.</p> <p>22 Q. And to pull it all together, do you recognize what</p> <p>23 Exhibit 2-5 reflects?</p> <p>24 A. Yes.</p> <p>25 Q. What is it?</p>
<p style="text-align: right;">Page 91</p> <p>1 THE COURT: Have you gotten the paper copy you could</p> <p>2 get marked, because we don't have --</p> <p>3 MR. SJOBLOM: Sure.</p> <p>4 THE COURT: Would you please hand it to my courtroom</p> <p>5 deputy to get it marked?</p> <p>6 (Discussion off record.)</p> <p>7 THE COURT: It would be Defendants' 2, Exhibit No.</p> <p>8 2, consisting of two pages. One exhibit has three pages in</p> <p>9 it. And would you give Mr. Sjoblom a sticker?</p> <p>10 MR. SJOBLOM: And may I just staple it together?</p> <p>11 THE COURT: Yes, sir.</p> <p>12 So we have that taken care of.</p> <p>13 MR. SJOBLOM: All right. Here we go.</p> <p>14 THE COURT: Okay. Thank you.</p> <p>15 MR. SJOBLOM: Except this is the wrong number. It's</p> <p>16 No. 2.</p> <p>17 THE COURTROOM DEPUTY: (Complying.)</p> <p>18 THE COURT: She does not have a No. 1 yet.</p> <p>19 Okay.</p> <p>20 MR. SJOBLOM: Okay. Let the record reflect that</p> <p>21 I've marked for identification as Defendants' Exhibit No. 1.</p> <p>22 THE COURT: No. 2.</p> <p>23 MR. SJOBLOM: Excuse me. No. 2. It's a five-page</p> <p>24 document consisting of 2-1, 2-2, 2-3, 2-4, and 2-5.</p> <p>25 THE COURT: Okay. Are you going to try to finish</p>	<p style="text-align: right;">Page 93</p> <p>1 A. The operations of HealthSouth as a whole.</p> <p>2 Q. The operations as well as the accounting side of the</p> <p>3 chief financial officer; correct?</p> <p>4 A. That's correct.</p> <p>5 Q. So what we have is a -- Well, strike that.</p> <p>6 Your interface is with the operations side on the common</p> <p>7 side; correct?</p> <p>8 A. That's correct.</p> <p>9 Q. You create numbers and provide them to the</p> <p>10 administrators; is that right?</p> <p>11 A. No. We don't provide numbers to the administrators.</p> <p>12 Q. Just created within the accounting side --</p> <p>13 A. Yes.</p> <p>14 Q. -- and it flows upstream?</p> <p>15 A. That's true.</p> <p>16 Q. All right. Ultimately results in consolidated financial</p> <p>17 statements to get presented to the presidents, chief</p> <p>18 operating officer, and then ultimately the chairman; is that</p> <p>19 correct?</p> <p>20 A. That's correct.</p> <p>21 Q. Were you aware of that?</p> <p>22 A. Yes.</p> <p>23 Q. So you were aware that what you were generating in the</p> <p>24 accounting department would ultimately result in a</p> <p>25 consolidated financial statement that would land on the desk</p>

<p style="text-align: right;">Page 94</p> <p>1 of Mr. Scrusby?                  2 A. That's correct.                  3 Q. At any time, Mr. Vines, did you tell any of these senior                  4 management people, and most especially Mr. Scrusby, that you                  5 were involved in the fabrication of these numbers?                  6 A. No, I did not.                  7 MR. SJOBLOM: Your Honor, we would move for the                  8 admission of Defendants' Exhibit No. 2.                  9 THE COURT: It's admitted.                  10 MR. SJOBLOM: Thank you.                  11 And I would also like to move for the admission of                  12 Defendants' Exhibit No. 5, which is a document entitled                  13 "Pulling the Wagon, Integrity in Action."                  14 THE COURT: Okay.                  15 MR. LOOMIS: Object to that. Lack of foundation. I                  16 don't think he's ever told us he's ever seen this before.                  17 THE COURT: I'm going to sustain the objection with                  18 respect to that document except for Page 6.                  19 MR. SJOBLOM: May I try, Your Honor, to lay a                  20 foundation?                  21 THE COURT: Oh sure. That will be fine.                  22 Q. Have you ever seen this document, Mr. Vines?                  23 A. Yes.                  24 Q. You had it in your possession while at HealthSouth?                  25 A. Yes.</p>	<p style="text-align: right;">Page 96</p> <p>1 THE COURT: You are talking about the very first                  2 page?                  3 THE WITNESS: Yes.                  4 THE COURT: Okay.                  5 Q. And the three -- well, the two programs are identified                  6 there. The compliance hot line, you're familiar with it,                  7 is that correct?                  8 A. Yes.                  9 Q. And the corporate compliance program, are you familiar                  10 with that?                  11 A. Yes.                  12 Q. Now, let's just focus on the statistics. I'm directing                  13 your attention to Page 2 of the first exhibit under Tab 4.                  14 It's called compliance hot line statistics. Do you see that                  15 page?                  16 A. Yes, I do.                  17 Q. Are you aware of the number of matters that have been                  18 reported since that hot line has been in the company?                  19 A. This is the first time I've seen it.                  20 Q. Okay.                  21 Are you aware of the number of active cases that might                  22 have been pending within the company?                  23 A. No. I'm no longer with HealthSouth.                  24 Q. Would you have seen this document previously?                  25 A. No, I have never seen it. It's the first time I've seen</p>
<p style="text-align: right;">Page 95</p> <p>1 Q. And you are familiar with the contents of this document?                  2 A. Yes, I am.                  3 Q. Including the compliance hot line, the business conduct,                  4 the code of ethics, everything --                  5 A. Yes.                  6 MR. SJOBLOM: Okay. I would move for its                  7 introduction.                  8 THE COURT: It's admitted.                  9 Q. Also No. 4 we talked about -- I'll take that back. We                  10 didn't talk about that.                  11 Do you recognize what's under Tab 4, that is --                  12 THE COURT: You ask him a question and get an                  13 answer.                  14 MR. SJOBLOM: I want him to identify it.                  15 THE COURT: I know. But that's what I want him to                  16 do. Otherwise, I don't know if he knows what it is. I know                  17 you know what it is.                  18 Now, do you recognize what's under Tab 4?                  19 THE WITNESS: Yes.                  20 THE COURT: Okay.                  21 Q. What is it?                  22 A. It's the executive vice president of corporate                  23 compliance.                  24 THE COURT: Is it on the report?                  25 THE WITNESS: It's on the --</p>	<p style="text-align: right;">Page 97</p> <p>1 this document.                  2 Q. Okay.                  3 MR. SJOBLOM: I believe that's it for me, Your                  4 Honor.                  5 THE COURT: Okay.                  6 Q. Thank you, Mr. Vines.                  7 A. Thank you.                  8 THE COURT: Just a minute. They may have some.                  9 REDIRECT EXAMINATION                  10 BY MR. LOOMIS:                  11 Q. Mr. Vines, when we spoke previously, did I provide you                  12 any documents, the SEC forms and all?                  13 A. Yes.                  14 Q. What was that that I provided you?                  15 A. Saying that I would come and do my testimony for the SEC                  16 the knowledge that I knew at HealthSouth.                  17 Q. Right. Do you recall whether that document was entitled                  18 anything?                  19 A. I can't remember the name of it.                  20 Q. Did it talk about the uses of information that we might                  21 do with the information you'd given us?                  22 A. Yes.                  23 Q. Do you recall what it said?                  24 A. No, I do not.                  25 Q. Do you recall what it said about any consequences for</p>

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<p>1 giving us false information?                  2 A. Yes.                  3 MR. SJOBLUM: Objection. Leading the witness. It's                  4 his witness.                  5 THE COURT: If you have a copy of the document, you                  6 may show him --                  7 MR. LOOMIS: Unfortunately, we don't, Your Honor,                  8 but we will have one after lunch.                  9 THE COURT: Okay. I'll sustain the objection.                  10 Don't lead.                  11 MR. LOOMIS: Okay.                  12 Q. Do you recall whether -- Strike that.                  13 Did we have any conversations about what the Department                  14 of Justice might do to you or with you?                  15 A. No. You just told me that my testimony would help out in                  16 the investigation of HealthSouth and you didn't see any way                  17 any charges could be brought against me.                  18 Q. When you say any charges, did you know if I was referring                  19 to the SEC or to the Department of Justice?                  20 A. I thought you were talking about the SEC and the                  21 Department of Justice.                  22 Q. That's your understanding?                  23 A. Yes.                  24 THE COURT: Did you sign a document of some kind?                  25 THE WITNESS: No, I did not.</p>	<p>1 MR. SJOBLUM: I'm sorry.                  2 THE COURT: Yeah. I asked him if he signed any                  3 documents and he said no.                  4 MR. SJOBLUM: I have no further questions.                  5 THE COURT: You may be excused.                  6 MR. LOOMIS: Your Honor, we would call Teresa                  7 Sanders to the stand. I think she's in the witness room.                  8 THE COURT: I tell you, the clock on the wall is                  9 completely messed up. I'm going by my computer.                  10 Oh yeah. And would you all take all your things down?                  11 Would you please take your things down?                  12 MR. SJOBLUM: Sure.                  13 THE COURTROOM DEPUTY: They are working on the                  14 clock.                  15 THE COURT: That might be why it isn't working.                  16 MR. HICKS: I don't know how long this witness will                  17 go. Do you want to have the lunch break now or --                  18 THE COURT: Is that convenient?                  19 MR. HICKS: That's up to you. Because then we could                  20 obtain that document while Mr. Vines is still around.                  21 THE COURT: Okay. That will be fine. Come back at                  22 1 o'clock, an hour and 10 minutes.                  23 MR. HICKS: Thank you, Your Honor.                  24 THE COURT: Actually, we can secure the courtroom if                  25 the attorneys would like to leave their stuff here. But I'd</p>
Page 99	Page 101
<p>1 MR. LOOMIS: One moment, Your Honor.                  2 Oh. Your Honor, I would actually move to admit Exhibits                  3 1, 2, and 3.                  4 THE COURT: They are admitted.                  5 Anything else?                  6 MR. SJOBLUM: I have just one question or two.                  7 THE COURT: Hold it a minute. I don't know if he's                  8 through.                  9 Were you through?                  10 MR. LOOMIS: Yes, ma'am, Your Honor.                  11 THE COURT: Okay.                  12 MR. SJOBLUM: I have one question and I think one                  13 request.                  14 RE-CROSS EXAMINATION                  15 BY MR. SJOBLUM:                  16 Q. Mr. Vines, have you ever spoken to lawyers for the                  17 government, officers of the government, where both the                  18 Department of Justice and the SEC are present in the room?                  19 A. The only person I've spoken to from the SEC is Graham                  20 Loomis.                  21 MR. SJOBLUM: I'd ask, Your Honor, that this witness                  22 be retained until that document is produced by the SEC to see                  23 if he signed any such document.                  24 THE COURT: He said he didn't sign anything. I just                  25 asked him about it.</p>	<p>1 like for all the spectators to take all their stuff with                  2 them.                  3 (Lunch recess from 11:48 a.m. to 1 p.m.)                  4 AFTERNOON SESSION                  5 THE COURT: Would you let the record show this is                  6 after lunch. Mr. Hicks is here. Mr. Loomis. Mr. Rue. Mr.                  7 Hood is here. Mr. Gillis?                  8 MR. WATKINS: He should be here shortly.                  9 THE COURT: Mr. Richey?                  10 MR. WATKINS: He's not in the courtroom.                  11 THE COURT: You just have to tell me they are here                  12 or not. I don't see them. Do you need to wait?                  13 MR. WATKINS: No.                  14 THE COURT: Mr. Balber? He's not here?                  15 MR. WATKINS: No.                  16 THE COURT: Mr. Mays?                  17 MR. MAYS: Yes, Your Honor.                  18 THE COURT: Mr. Watkins is here. Mr. Sjoblum is                  19 here. I'm trying to see. Mr. Rose is not here. Mr.                  20 McDermott is not here.                  21 Yeah, you are here. Are you going to proceed without                  22 him?                  23 MR. WATKINS: Yes.                  24 THE COURT: Are you ready to proceed?                  25 (Discussion off record.)</p>

<p style="text-align: right;">Page 102</p> <p>1 THE COURT: I understood you were going to call  2 Teresa Sanders as your next witness.  3 MR. LOOMIS: Actually, Your Honor, we would call  4 Diane Henze to the stand.  5 DIANA OLSZEWSKI HENZE  6 was sworn/affirmed and testified as follows:  7 BY THE COURTROOM DEPUTY:  8 Q. Will you state your full name for the record?  9 A. Diana Olszewski Henze.  10 THE COURT: Wait just a minute. How do you spell  11 your middle name?  12 A. O-l-s-z-e-w-s-k-i.  13 Q. First name?  14 A. D-i-a-n-a, H-e-n-z-e.  15 Q. The city and the state where you live?  16 A. Birmingham, Alabama.  17 THE COURT: Would you please speak up?  18 DIRECT EXAMINATION  19 BY MR. LOOMIS:  20 Q. Ms. Henze, could you tell me where you're currently  21 employed?  22 A. I'm currently employed at HealthSouth.  23 Q. And what is your title?  24 A. Vice President of Internet Operations.  25 Q. Have you had any prior titles prior to becoming Vice</p>	<p style="text-align: right;">Page 104</p> <p>1 THE COURT: May I ask when you became employed at  2 HealthSouth? I know you said you were still employed, but  3 when did you become employed?  4 THE WITNESS: I was part of the ReLife acquisition,  5 so it was -- Officially, I started working with HealthSouth  6 December of '94, when they acquired ReLife.  7 THE COURT: And when did you become Vice President  8 of Finance?  9 THE WITNESS: I became Assistant Vice President in  10 '97, and I believe in '98 I became vice president.  11 THE COURT: Okay. And when did you take over as  12 Vice President of Internet Operations?  13 THE WITNESS: In 2000.  14 THE COURT: Okay.  15 BY MR. LOOMIS:  16 Q. I believe my question was while you were Vice President  17 of Finance at HealthSouth, did you ever develop any concerns  18 about the HealthSouth financial statements?  19 A. Yes.  20 Q. Tell me about that.  21 A. During the consolidation process, it was about the middle  22 of '98, I had prepared consolidations and handed those over  23 to senior management for review.  24 THE COURT: Tell me the persons.  25 THE WITNESS: I'm sorry. I handed them over to Ken</p>
<p style="text-align: right;">Page 103</p> <p>1 President of Internet Operations?  2 A. Yes, I have.  3 Q. What were they?  4 A. Vice President of Finance.  5 Q. Can you describe for me your responsibilities as the Vice  6 President of Finance at HealthSouth?  7 A. My responsibilities were to prepare the consolidation  8 statements and elimination entries.  9 Q. Could you be a little bit more specific about preparing  10 the consolidation statements?  11 A. Financial accounting was responsible for preparing  12 journal entries and doing the financial books at the  13 facilities and looking at it from a divisional level. My  14 responsibility was when they were through preparing their  15 entries and doing their analysis was to take the -- all the  16 entities and roll them up into a consolidated statement, a  17 very summarized consolidated statement.  18 Q. For the entire HealthSouth Corporation?  19 A. For the entire HealthSouth Company -- HealthSouth  20 Corporation and prepare elimination entries.  21 Q. And while you were Vice President of Finance at  22 HealthSouth, did you ever develop any concerns about the  23 financial statements at HealthSouth?  24 A. Yes, I did.  25 Q. Tell me about those.</p>	<p style="text-align: right;">Page 105</p> <p>1 Livesay who is the assistant controller. And then a few days  2 later after, I guess, meetings, I was asked to open up the  3 books so they could make adjusting entries.  4 THE COURT: Who is "they"?  5 THE WITNESS: My boss, Ken Livesay and Emery Harri  6 who was -- I don't exactly know his title at that point in  7 time.  8 THE COURT: You were told to do what, now?  9 THE WITNESS: To open up -- in the closing process  10 you actually close the periods so that entries can be made  11 into that accounting period. So that you can officially  12 close that period and go on to the next one so no accidental  13 entries could get in. I was asked to open them up because  14 there were some adjustments that needed to be made. So I  15 opened up the periods. They re-booked some entries. I was  16 asked to re-run some consolidations, and earnings had changed  17 dramatically in that time between the two entries --  18 BY MR. LOOMIS:  19 Q. When you say dramatically, can you give us an estimate of  20 how much?  21 A. I don't recall dollar amount. It was enough to have  22 earnings per share changed by a couple of cents.  23 Q. Okay. Did you ever discuss these concerns with anybody  24 at HealthSouth?  25 A. Yes, I did. During that time, I brought my concerns up</p>

<p style="text-align: right;">Page 106</p> <p>1 to Ken Livesay and asked him, you know, this has changed very</p> <p>2 significantly; do we have enough reserves to account for</p> <p>3 these changes?</p> <p>4 Q. And what was his response?</p> <p>5 A. His response was, yes, we do.</p> <p>6 Q. Did the event that you've just described that caused you</p> <p>7 concern, did that reoccur after your conversation with Mr.</p> <p>8 Livesay?</p> <p>9 A. Yes, it did. It did the following quarter -- pretty much</p> <p>10 every quarter, it seemed to occur.</p> <p>11 Q. And did you express any additional concerns to anybody</p> <p>12 else at HealthSouth?</p> <p>13 MR. SJOBLÖM: Object, Your Honor. Could we have</p> <p>14 some foundation of these conversations? I realize Mr. Loomis</p> <p>15 is moving on to yet another person. You were talking about</p> <p>16 conversations with Mr. Livesay, but when, what time period?</p> <p>17 We need some foundation.</p> <p>18 THE COURT: You mean just in terms of the</p> <p>19 approximate time period?</p> <p>20 MR. SJOBLÖM: Right.</p> <p>21 THE COURT: Absolutely.</p> <p>22 BY MR. LOOMIS:</p> <p>23 Q. When was this conversation with Mr. Livesay?</p> <p>24 A. The first one?</p> <p>25 Q. Yes, ma'am.</p>	<p style="text-align: right;">Page 108</p> <p>1 THE WITNESS: Reserves?</p> <p>2 THE COURT: What do you mean when you say there were</p> <p>3 not significant reserves?</p> <p>4 THE WITNESS: When I first approached, I was told</p> <p>5 that they are reversing out some reserves. The main reserve</p> <p>6 that I was told they were reversing was bonus accrual</p> <p>7 reserves, bonus accruals. You accrue in expense every month</p> <p>8 to pay out bonuses for the corporation one time.</p> <p>9 THE COURT: Okay.</p> <p>10 THE WITNESS: So you allocate that monthly. You</p> <p>11 approve that. I was told at that time that they were</p> <p>12 reversing out that huge accrual that had accrued.</p> <p>13 THE COURT: Okay.</p> <p>14 THE WITNESS: And they also mentioned something</p> <p>15 about home office provision, but I'm not familiar enough with</p> <p>16 the basis of home office to really even question whether --</p> <p>17 anything about that. I just took it that that was okay.</p> <p>18 THE COURT: Okay.</p> <p>19 THE WITNESS: When I returned from maternity leave,</p> <p>20 it became very apparent that there wasn't nothing, you know,</p> <p>21 that these just weren't right.</p> <p>22 BY MR. LOOMIS:</p> <p>23 Q. You say "these." Can you be a little bit more specific?</p> <p>24 A. That the changes in the consolidations weren't right.</p> <p>25 Q. You say changes in consolidations?</p>
<p style="text-align: right;">Page 107</p> <p>1 A. About midyear of 1998.</p> <p>2 THE COURT: Okay. I don't think everybody</p> <p>3 understood that.</p> <p>4 THE WITNESS: Okay.</p> <p>5 BY MR. LOOMIS:</p> <p>6 Q. Okay. I guess my question was, did you have --</p> <p>7 THE COURT: She testified that it occurred every</p> <p>8 quarter thereafter.</p> <p>9 MR. LOOMIS: Right.</p> <p>10 THE COURT: And then your next question was, did</p> <p>11 you --</p> <p>12 BY MR. LOOMIS:</p> <p>13 Q. Right. Did you have any subsequent discussions about any</p> <p>14 concerns? And I'll leave that open. Did you have any</p> <p>15 subsequent discussions about your concerns?</p> <p>16 A. Yes, I did.</p> <p>17 Q. Can you tell me when, approximately?</p> <p>18 A. Approximately, it was either March of '99 or April of</p> <p>19 '99. I had just gotten back from maternity leave, so I know</p> <p>20 it was around that time.</p> <p>21 Again, at that point, it was very apparent. I was much</p> <p>22 more concerned about the numbers, and I approached Ken</p> <p>23 Livesay again about that I don't -- it didn't appear that</p> <p>24 there were significant reserves.</p> <p>25 THE COURT: Now, explain that to me.</p>	<p style="text-align: right;">Page 109</p> <p>1 A. The changes or the fluctuations in the net income that</p> <p>2 was from one consolidation to the next, within one quarter.</p> <p>3 Q. When you returned from maternity leave, did you express</p> <p>4 these concerns to anybody at HealthSouth?</p> <p>5 A. I expressed them to Ken Livesay, and I was called in to</p> <p>6 Bill Owens' office and expressed my concerns.</p> <p>7 MR. SJOBLÖM: I'm sorry. You were charged to do</p> <p>8 what?</p> <p>9 THE WITNESS: Excuse me? I didn't hear you.</p> <p>10 THE COURT: She said she spoke to Mr. Livesay. And</p> <p>11 I don't understand how you got to Bill Owens' office, but you</p> <p>12 said you ended up there?</p> <p>13 THE WITNESS: Yes. I believe Ken approached Bill</p> <p>14 with my concerns.</p> <p>15 BY MR. LOOMIS:</p> <p>16 Q. Did you have a conversation with Mr. Owens?</p> <p>17 A. Yes, I did.</p> <p>18 Q. Roughly when was this?</p> <p>19 A. That was either March of '99 or April of '99.</p> <p>20 Q. Tell us about that.</p> <p>21 A. I told him that I was very concerned that these weren't</p> <p>22 valid adjustments and basically accused him that there were</p> <p>23 fraudulent entries that were being made.</p> <p>24 Q. And what was Mr. Owens' response?</p> <p>25 A. His response to me was that it was something that they</p>

<p style="text-align: right;">Page 110</p> <p>1 had to do. That if -- I don't actually know his words. But  2 paraphrasing, if they didn't make earnings or did --  3 something, that the company would -- it would affect the  4 company and people would start losing their jobs.  5 Q. And did you have any subsequent conversations with  6 anybody else at HealthSouth about your concerns?  7 A. Yes, I did.  8 Q. When roughly was that?  9 A. I would say it was either mid-October to early November,  10 I went to our Compliance.  11 Q. And who was that?  12 A. Kelly Cullison.  13 Q. Tell me about that.  14 A. After watching what was going on and still having high  15 concerns that the numbers were changing so much, that I went  16 to Kelly's office and told her that I had some concerns that  17 there were some fraudulent activity occurring within  18 accounting.  19 Q. And what was Ms. Cullison's response?  20 A. Her response was that she had heard rumors, but yet I was  21 the first person that had actually come forward.  22 Q. Now, during all this time that you had concerns about the  23 financial statements, why did you just not leave HealthSouth?  24 A. I was actually told when I asked to transfer out, prior  25 to transferring out, I was told that it was stopping, it was</p>	<p style="text-align: right;">Page 112</p> <p>1 the internet. I committed to him that I would help him get  2 it up and get it running and get it live out there in  3 production. Once we got it up, it turned into a department.  4 And he asked if I would stay on and help him develop, create  5 this department, and get it up and running. And I committed  6 to him to help him do that.  7 Q. Did you ever interview for any other jobs?  8 A. I interviewed for a few jobs, yes, in the interim.  9 Q. Can you give us an idea when that was?  10 A. It was in 1999 and the first part of 2000.  11 Q. In your position as VP of Finance, would assistant  12 controller have been above you?  13 A. Yes.  14 Q. Were you ever passed up for a promotion to assistant  15 controller?  16 A. I feel like I was passed up for a promotion.  17 Q. Did you ever have any discussions with anybody about  18 being passed up?  19 A. I approached Bill Owens directly about that.  20 Q. When was this?  21 A. That was in December of '99.  22 Q. And what was Mr. Owens' response?  23 A. His response to me, and this is not verbatim, but it was  24 that in good faith he could not have promoted me because I  25 refused to do what they asked to have done.</p>
<p style="text-align: right;">Page 111</p> <p>1 all being reversed and it wasn't going to happen again.  2 Q. Who was that that told you that?  3 A. That was Bill Owens. And I had faith in --  4 MR. SJOBLOM: Objection. Foundation as to when  5 that conversation took place, when Mr. Owens said that.  6 THE COURT: She said it was right before she  7 transferred out to Internet, which would have been in 2000.  8 THE WITNESS: That was actually in December of '99.  9 THE COURT: Okay.  10 THE WITNESS: And I was actually transferring into  11 it at that time.  12 What was the question?  13 THE COURT: The question was, I think you started --  14 I'm not sure what the question was, but I think you started  15 saying something about you questioned Mr. Owens and he said  16 it was stopping.  17 THE WITNESS: Oh. Why was I staying.  18 BY MR. LOOMIS:  19 Q. I asked you why did you not leave HealthSouth?  20 A. I was told it was stopping. I believed in HealthSouth.  21 I believed in what the company stands for. I was leaving,  22 going into IT to learn something new.  23 In the process of going there or after -- or shortly  24 after I got there, I was asked to work on the internet  25 project. And I committed to the person who was developing</p>	<p style="text-align: right;">Page 113</p> <p>1 MR. LOOMIS: No further questions, Your Honor.  2 MR. SJOBLOM: May I have a moment, Your Honor?  3 (Pause.)  4 CROSS EXAMINATION  5 BY MR. SJOBLOM:  6 Q. Good afternoon, Ms. Henze. My name is Tom Sjoblom. I  7 represent Mr. Scrusby in this matter. I think I'd like to  8 start by asking you some questions about your duties.  9 When you were Assistant VP of Finance in 1997, what were  10 your duties?  11 A. In 1997, my main duties were to take the numbers that  12 were created from general accounting and consolidate them up  13 into a GAAP format statement.  14 MR. SJOBLOM: Your Honor, if I might, I would like  15 to put that demonstrative exhibit back up.  16 THE COURT: Why don't you just use a piece of  17 paper?  18 BY MR. SJOBLOM:  19 Q. Ms. Henze, do you have an exhibit that looks something  20 like this big chart?  21 Ms. Henze, I've put before you what has been marked as  22 Defendants' Exhibit No. 2. Let's just start with Page 1 of  23 that Exhibit 2-1.  24 Is it your understanding that the corporate structure of  25 HealthSouth was such that there was a finance and accounting</p>

<p style="text-align: right;">Page 114</p> <p>1 department on the one hand and operations on the other?                  2 A. Yes.                  3 Q. If you'll turn to the next page, Exhibit 2-2, strictly                  4 within the finance and accounting department, if you will                  5 look at the second box at the top of the page, you were aware                  6 that there are essentially five directorships, if you will,                  7 or officerships, under the Finance and Accounting staff? For                  8 example, Director of Internal Audit, Director of                  9 Reimbursement, Chief Financial Officer; is that correct?                  10 A. I believe so.                  11 Q. And where is Vice President of Finance -- Assistant VP of                  12 Finance, where do you fall in this chart?                  13 A. There are several Assistant Vice Presidents of Finance                  14 that all went into different areas underneath Chief Financial                  15 Officer. My particular position reported directly to the                  16 Assistant Controller at that time.                  17 Q. So you are on this chart. If you look down towards the                  18 bottom right, you'll see a portion of the chart called                  19 General Accounting, Accounting Supervision.                  20 A. Uh-huh.                  21 Q. Were you in that group of people --                  22 A. No, I was not.                  23 Q. You were higher than that?                  24 A. I wouldn't say I was higher than that. I am saying that                  25 I was not in that area.</p>	<p style="text-align: right;">Page 116</p> <p>1 THE COURT: Did you do that every month?                  2 THE WITNESS: We did what I term a soft close every                  3 month. Which basically, I just ran it. It's a processing                  4 order to consolidate the numbers and then to close the                  5 periods. Quarterly is really -- Yes, I did it every                  6 month.                  7 BY MR. SJOBLUM:                  8 Q. What type of documentation did you have at your disposal                  9 or information at your disposal to prepare these consolidated                  10 figures?                  11 A. All I had was the computer to run consolidations. It's a                  12 process on the computer.                  13 Q. Let me rephrase that. Maybe I'm not making myself                  14 clear. The information that you used to prepare the                  15 consolidated financial statement, what was that information?                  16 Information that was provided from the accounting department                  17 on a computer, were you provided hard documents, were you                  18 provided with the review reports --                  19 A. No.                  20 Q. What was it?                  21 A. It was when they said they were done, I would go into --                  22 Q. "They" meaning general accounting?                  23 A. "They," the accountants, general accounting.                  24 Specifically Emery Harris over General Accounting and Kay                  25 Morgan over General Corporate Accounting would say they were</p>
<p style="text-align: right;">Page 115</p> <p>1 Q. So if we come up that chart on the bottom right, up and                  2 then across the middle of the page, we'll see the middle, the                  3 Assistant Controller some place in there --                  4 A. I reported directly to the Assistant Controller.                  5 THE COURT: And that was Ken Livesay.                  6 THE WITNESS: That was Ken Livesay.                  7 BY MR. SJOBLUM:                  8 Q. Okay. Now, what were your duties specifically in that                  9 task?                  10 A. Was to run consolidations, to prepare GAAP format                  11 statements, to put those into the 10-Q form for the Assistant                  12 Controller and the Controller. That was my financial                  13 duties. The other duties I had were on the IT side, is to                  14 manage the accounting system.                  15 Q. Before we shift to that side, I want to understand the                  16 finance side. When you say you put the numbers together for                  17 consolidation purposes or working the consolidation process,                  18 what do you mean by that?                  19 A. That after general accounting, the one in the lower                  20 right-hand corner said that they were completed with their                  21 journal entries and their analysis for the month, my job was                  22 to run a consolidation that took all the 2000 -- 1500                  23 facilities' income statements or statement and consolidate                  24 them up into the corporation, to one financial statement.                  25 Q. Okay.</p>	<p style="text-align: right;">Page 117</p> <p>1 through. At that point I would go into the computer, I would                  2 close the period so no other processing could take place and                  3 I would run a process called consolidation, which would then                  4 take all the numbers that had been inputted from general                  5 accounting and it would consolidate it up into what we termed                  6 a GAAP format statement.                  7 Q. If I heard your testimony right, Emery Harris was                  8 reporting up to you?                  9 A. No. Emery Harris would tell me that he was through. He                  10 also reported directly to Ken Livesay.                  11 Q. He's your equal, if you will, in the hierarchy?                  12 A. I would say we were peers, yes.                  13 Q. Did anyone from general accounting ever indicate to you                  14 or apprise you that there were some phantom figures being                  15 developed?                  16 A. Not directly, no.                  17 Q. Well, what about indirectly? Did you ever have anyone                  18 like Cathy Edwards or any of the supervisors for the Midwest                  19 the East or the West, indicate to you that there was an                  20 artificial inflation of the property, plant and equipment                  21 account?                  22 A. Did they actually come and tell me there was some                  23 artificial -- is that what you're asking me?                  24 Q. Yes.                  25 A. Nobody from operation account -- nobody from the</p>

<p style="text-align: right;">Page 118</p> <p>1 operational side ever approached me.                  2 Q. How about the general accounting staff?                  3 A. No. It was mostly my inquiry --                  4 Q. You seem to be hesitating in thinking about whether or                  5 not you ever received any type of information. Should we                  6 move away from direct to some other way the information came                  7 to your attention that you're pausing?                  8 A. Most information that came to my attention was seeing the                  9 numbers fluctuate and a conversation that I did have with                  10 Cathy Edwards.                  11 Q. Let's take them one at a time. Tell me about the numbers                  12 that fluctuate. What are you talking about?                  13 A. Net income on a consolidated basis.                  14 THE COURT: That would be for the entire                  15 corporation?                  16 THE WITNESS: For the entire corporation. I did not                  17 look at detail.                  18 BY MR. SJOBLOM:                  19 Q. What exactly did you see fluctuate?                  20 A. Net income. I was not in a position to analyze. And the                  21 GAAP format statement is a nine-line statement as opposed to                  22 a detailed financial statement which is very detailed with                  23 line items. We're talking net revenues, depreciation,                  24 amortization, income taxes, net income. It was very                  25 consolidated.</p>	<p style="text-align: right;">Page 120</p> <p>1 THE WITNESS: They never handed me numbers.                  2 THE COURT: I understand that. They put them in the                  3 computer.                  4 THE WITNESS: They put them in the computers. They                  5 would say, "We're through" --                  6 THE COURT: Right.                  7 THE WITNESS: And I would --                  8 THE COURT: Consolidate them.                  9 THE WITNESS: I would basically say, okay, take all                  10 this information and roll it up into one.                  11 THE COURT: And you had a computer program that did                  12 that the way you wanted it done?                  13 THE WITNESS: Our accounting software did that. Our                  14 accounting package did that.                  15 THE COURT: What I want to know is, when you say                  16 fluctuations in the net income of the entire corporation                  17 during that period of time, are you talking about from                  18 quarter to quarter?                  19 THE WITNESS: No. I'm talking about within a                  20 quarter when I'm asked to run the first consolidation when                  21 they say they are done and I hand them a consolidation --                  22 "them" being Ken Livesay is who I physically handed it to --                  23 and within two or three days of asking to open up the period,                  24 they needed to make some adjustments and then re-running that                  25 consolidation.</p>
<p style="text-align: right;">Page 119</p> <p>1 Q. Did you see any of the break-out, any of those subsidiary                  2 registers, or you just got a consolidated?                  3 A. I just did -- I just handled consolidated statements,                  4 consolidated statements.                  5 Q. Who is the person prior to you in the process who was                  6 integrating and compiling subledgers?                  7 A. That would be general accounting.                  8 Q. Who beneath you?                  9 A. There was nobody beneath me. I was my own department.                  10 Q. What I mean by that, it sounds like you are getting                  11 consolidated figures, that someone has already integrated and                  12 consolidated these numbers. There is a step prior to coming                  13 to you. There is a person taking subsets, ledgers,                  14 categories, line items, as you call them, to compile them and                  15 to present them to you?                  16 A. That is a computer process that does that. It's all                  17 systematically done.                  18 THE COURT: What she's testified to, if I                  19 understand -- let me see if I've understood you correctly --                  20 you got some figures from general accounting that Emery                  21 Harris and Kay Morgan said they were through, they gave you                  22 some figures, and you closed that period. And typically that                  23 was a quarter. And then you had a computer program that                  24 allowed you to consolidate that for the corporation for that                  25 period.</p>	<p style="text-align: right;">Page 121</p> <p>1 THE COURT: Oh. Okay. So that happened every                  2 quarter?                  3 THE WITNESS: That happened every quarter.                  4 THE COURT: Since the first time in 1998?                  5 THE WITNESS: That's when I first noticed it that it                  6 became significant, yes.                  7 THE COURT: Okay. Those are the fluctuations you're                  8 talking about?                  9 THE WITNESS: I'm talking about those. Now, it's                  10 not unusual to have some adjustments, but the amount of                  11 adjustments is what triggered my suspicion.                  12 THE COURT: So is it your testimony, do I understand                  13 you correctly, that by the time you had done your work and                  14 Ken Livesay told you to do some adjustments a few days later                  15 that the net earnings would go up?                  16 THE WITNESS: When I would first do my work, they                  17 would meet on the numbers.                  18 THE COURT: Right.                  19 THE WITNESS: And discuss the numbers. They would                  20 ask me to reopen the period so they at general accounting                  21 could make some adjusting entries.                  22 THE COURT: Right. Right.                  23 THE WITNESS: And then when they were through, they                  24 would ask me to re-run a consolidation, and then I would hand                  25 that consolidation back to them.</p>

<p style="text-align: right;">Page 122</p> <p>1 THE COURT: I'm talking about the first                  2 consolidation you did --                  3 THE WITNESS: Okay.                  4 THE COURT: -- to the second consolidation you did                  5 for the same period. What were the fluctuations?                  6 THE WITNESS: Dollar amounts, I do not know the                  7 fluctuations. The main thing that triggered my suspicion was                  8 that net income would increase dramatically.                  9 THE COURT: Okay. That's what I'm talking about.                  10 Okay. I understand what you're saying. Did you ever go                  11 back -- would you go back into what you had been furnished                  12 by accounting to see what figures had been changed in order                  13 to show this increase in net income?                  14 THE WITNESS: I never did, no.                  15 THE COURT: Could you have?                  16 THE WITNESS: Yes, I guess I could have.                  17 THE COURT: But you went to Mr. Livesay?                  18 THE WITNESS: Yes.                  19 THE COURT: Okay.                  20 BY MR. SJOBLUM:                  21 Q. Did you ever have any discussions with Mr. Harris about a                  22 report being generated off the system?                  23 A. A report being generated off the system?                  24 Q. Right.                  25 A. I'm not sure what you're referring to.</p>	<p style="text-align: right;">Page 124</p> <p>1 statements and elimination entries and sum them up with our                  2 system entries.                  3 Q. Did Mr. Harris ever tell you that they were doing                  4 off-book systems or your third category that you just                  5 described?                  6 A. Did Mr. Harris tell me?                  7 Q. Ever say that to you?                  8 A. Not that I recall.                  9 Q. Did he ever bring to your attention -- Are you saying                  10 that it possibly happened but you don't recall it sitting                  11 here today, or you don't recall?                  12 A. I don't recall having any conversations with Mr. Harris.                  13 Q. About this topic? Or you didn't have a conversation with                  14 him at all?                  15 A. I had -- I worked every day. I saw him every day. So,                  16 yes, I had conversations with him.                  17 Q. That third group of information, what did you call that                  18 again, the third category? Off-book?                  19 A. Off-book entries, elimination entries.                  20 Q. Illumination, i-1-1?                  21 A. Elimination.                  22 Q. Elimination.                  23 A. Elimination entries.                  24 Q. What are off-book elimination entries?                  25 A. The entries that I'm familiar with that I did for</p>
<p style="text-align: right;">Page 123</p> <p>1 Q. Mr. Harris testified in a court proceeding in allocution                  2 that a report was generated off the system.                  3 A. A financial report?                  4 Q. Well, that's what we're trying to find out. Is there                  5 some way, since we're talking about -- we're talking about a                  6 computer program, would someone have the ability, before the                  7 consolidated figures come to you, to generate some                  8 information off the system that somehow then gets in the                  9 consolidated figures?                  10 A. The way the consolidations ran, because we have                  11 elimination entries that are done on a quarterly basis that                  12 are not booked, they're basically intercompany eliminations.                  13 They aren't booked entries. The way the consolidation ran is                  14 that once you ran your consolidation, your statement was a                  15 three-tab statement. Your actual numbers off the computer is                  16 an Excel spreadsheet actually. So you would have your                  17 consolidation numbers spit out by the computer.                  18 Your next sheet would be where you run your adjustments,                  19 non-book entries, mainly eliminations. And then you had the                  20 third sheet -- Actually, let me back up. On your adjustments                  21 we had a lot of acquisitions that took place that were not on                  22 our accounting system, so we would have to manually put in                  23 some of those month-end statements onto this adjustment entry                  24 in order to add those to our consolidated system entries.                  25 But the third sheet is the one that totalled these non-system</p>	<p style="text-align: right;">Page 125</p> <p>1 eliminations were where we had intercompany transactions                  2 taking place with entities within HealthSouth.                  3 Q. Would you give me an example?                  4 A. I can give you mainly on the balance sheet side. The way                  5 some of the legal structures were for companies, there may be                  6 a holding company that has a note receivable from one of the                  7 HealthSouth entities that shows a notes receivable on their                  8 books. An elimination entry, when you do a consolidation,                  9 from a single facility standpoint, that facility needs to                  10 recognize a note receivable and the other one needs to                  11 recognize a note payable. But in a consolidation process,                  12 you need to eliminate those off the books. A note payable                  13 needs to be eliminated within a receivable.                  14 Instead of booking those entries systematically, month to                  15 month, quarter to quarter, we would actually do what I term                  16 an off-book entry where on this elimination sheet of the                  17 consolidation I would go through and say this is an                  18 intercompany note payable with this intercompany note                  19 receivable and eliminate them. That's why they are called                  20 eliminations.                  21 THE COURT: They would cancel each other out?                  22 THE WITNESS: They cancelled each other out. But if                  23 you looked at it as a consolidation, your notes payable was                  24 inflated and your notes receivable, so you eliminate them.                  25 BY MR. SJOBLUM:</p>

<p style="text-align: right;">Page 126</p> <p>1 Q. Are you familiar with some of the allegations in this 2 case by the government? 3 A. Just what I've read in the paper. 4 Q. In particular something called an AP summary. Have you 5 seen that? 6 A. Only what I've read in the paper. 7 Q. Does the AP summary in any way involve what you are 8 talking about in notes payable or accounts payable? 9 A. No. AP summary is from our system, our accounting 10 system. Our accounts payable subsidiary system, when it 11 sends its transactions into the general ledger, it comes over 12 as a lump total and the description is AP summary. 13 Q. So if there's phantom income -- excuse me -- phantom 14 asset inflation, that's already going to be part of the 15 information in the system before you get it? 16 A. Yes. 17 Q. Are you familiar with something called the gap or the 18 hole? 19 A. The gap or the hole? 20 Q. Yes. 21 A. Gap as in g-a-p or GAAP as in G-A-A-P? 22 Q. Not generally accepted accounting principles. Gap as in 23 the store, but not a store; just the word gap, g-a-p, in the 24 context of the accounting functions you perform or in the 25 context of this case.</p>	<p style="text-align: right;">Page 128</p> <p>1 Q. Would you or could you during this time you reopen for 2 current quarters, make adjustments to EBITDA? 3 A. Yeah. 4 Q. Such as? 5 A. They accrued some more revenue. That would increase your 6 earnings, which would increase your EBITDA. 7 Q. Would you see the reason for that adjustment for the 8 EBITDA, the source figures for it or the basis for that 9 EBITDA change? 10 A. I would never see those, no. 11 Q. Those, again, would happen down the line or downstream, 12 if I could put it that way? 13 A. Correct. 14 Q. That would be? 15 A. General accounting. 16 Q. Okay. So you might be asked by Livesay or someone to 17 reopen a current period, might be EBITDA changes, but those 18 EBITDA changes are done by the accounting staff? 19 A. Correct. 20 Q. And then brought back to you again; correct? 21 A. I would be asked to re-run a consolidation, yes. 22 Q. Okay. And then you said there were some of the entries 23 that were revoked. What do you mean they revoked entries? 24 A. Revoked? 25 Q. I thought that's what you said. You said some</p>
<p style="text-align: right;">Page 127</p> <p>1 A. What you're referring to, no. 2 Q. Now, you said that you were asked to reopen some of these 3 consolidation figures? 4 A. I was asked to reopen the current period for the quarter. 5 Q. If we're talking about the first quarter of the year, you 6 opened up those three -- 7 A. I would only open up the current month that we were in. 8 I would not open up the prior months within that quarter. 9 Q. Why would you open them up? 10 A. Because there are times that adjustment entries are 11 valid. 12 Q. Such as? 13 A. Tax provision. There could be something coming across 14 that there was a huge accrual, liability that we just became 15 aware of that we want to go ahead and approve for. There's 16 all kinds of different things that could happen, and it's not 17 unusual to have adjusting entries. 18 Q. Do you know what EBITDA is? 19 A. Earnings before income tax, depreciation -- 20 THE COURT REPORTER: I'm sorry? 21 MR. SJOBLOM: E-B-I-T-D-A. 22 BY MR. SJOBLOM: 23 Q. Do you know what that is? 24 A. Earnings before income tax, depreciation, and 25 amortization.</p>	<p style="text-align: right;">Page 129</p> <p>1 adjustments were made, but they -- whoever "they" are -- 2 revoked the entries? 3 A. I said "revoked"? 4 Q. Did you say that during your direct testimony? 5 A. I don't think so. I might have said they would have been 6 reversed entries. 7 Q. Okay. So it's reopened, there's an adjustment, and then 8 there's a reversal. Or when you're talking about the 9 reopening, is there a reversal? 10 A. It could be a reversing of accrual. It could be when I 11 was asked to -- I never saw the entries. These are all 12 assumptions that a reversing of an accrual could take place 13 between consolidations. 14 Q. You also mentioned something about there could be 15 acquisitions off the system; correct? 16 A. Yes. 17 Q. Was Mr. Owens in particular engaged in a lot of 18 acquisitions on behalf of HealthSouth? 19 A. I don't know. 20 Q. Were you involved in determining whether or not the 21 purchase accruing method of accounting applied to those 22 acquisitions? 23 A. No, I was not involved. 24 Q. Pardon me? 25 A. I was not involved when that took place.</p>

<p style="text-align: right;">Page 130</p> <p>1 Q. Did that happen downstream from you?</p> <p>2 A. The actual -- how the transaction would take place,</p> <p>3 whether it was an acquisition or accruing, or the actual</p> <p>4 consolidation of those statements with the opening entry of</p> <p>5 those acquisitions?</p> <p>6 Q. Believe me, you're the accountant. I'm just trying to</p> <p>7 understand. But you said that some of these three</p> <p>8 categories, in particular, this off-book, whatever you called</p> <p>9 that third category you mentioned as an example, acquisitions</p> <p>10 off the system?</p> <p>11 A. Uh-huh.</p> <p>12 Q. Okay. And I'm asking you whether or not in the process</p> <p>13 of your career, tenure at HealthSouth, not only as the</p> <p>14 Assistant VP of Finance but also as Vice President of</p> <p>15 Finance, Mr. Owens was engaged in extensive acquisitions for</p> <p>16 the company -- on behalf of the company?</p> <p>17 A. I guess he -- I don't know the acquisition part that took</p> <p>18 place.</p> <p>19 Q. Were you aware whether or not any of those acquisitions</p> <p>20 create a write-off?</p> <p>21 A. Not directly. I know that they have closed some</p> <p>22 facilities based on some of these acquisitions that weren't</p> <p>23 performing.</p> <p>24 Q. In your tenure there at HealthSouth in the Finance</p> <p>25 Department, did it ever come to your attention that there</p>	<p style="text-align: right;">Page 132</p> <p>1 Edwards. What conversations, when did they occur?</p> <p>2 A. I really only had one.</p> <p>3 Q. When was that?</p> <p>4 A. Don't know exactly the year.</p> <p>5 Q. You're an Assistant VP, or now you're a VP of Finance?</p> <p>6 A. I would say it was since I was Vice President of Finance.</p> <p>7 Q. So that's sometime 1998 to 2000?</p> <p>8 A. No. I was vice president from 1998 to 2000.</p> <p>9 Q. Maybe I misunderstood what you just said. When was the</p> <p>10 conversation with Cathy?</p> <p>11 A. When I was a vice president -- You asked if I was a vice</p> <p>12 president or assistant vice president, and I said vice</p> <p>13 president.</p> <p>14 Q. Yes. So this conversation with Cathy Edwards occurs in</p> <p>15 the period 1998 to 2000?</p> <p>16 A. Somewhere in that time frame. I'm not sure exactly of</p> <p>17 the time.</p> <p>18 THE COURT: Was it after just the first quarter that</p> <p>19 you had realized that or was it after more than one quarter?</p> <p>20 THE WITNESS: I believe it was after more than one</p> <p>21 quarter.</p> <p>22 THE COURT: Okay. Do you remember whether it was</p> <p>23 before your conversation with Mr. Owens or after?</p> <p>24 THE WITNESS: I really don't know.</p> <p>25 THE COURT: Okay.</p>
<p style="text-align: right;">Page 131</p> <p>1 were acquisitions occurring that were having an adverse</p> <p>2 financial impact on the financial statements?</p> <p>3 A. Only through whether -- only through whether</p> <p>4 operationally they were making money from an operational</p> <p>5 standpoint.</p> <p>6 Q. For example, whether there was a gross amount of good</p> <p>7 will that had to be written off or something like that.</p> <p>8 Anything like that?</p> <p>9 A. Not directly, no.</p> <p>10 Q. Okay. Now, you also said -- Well, before we go to the</p> <p>11 conversation with Cathy Edwards, what specifically were you</p> <p>12 seeing these fluctuations in information that gave you</p> <p>13 concern? You mentioned EPS might change one or two cents a</p> <p>14 share, earnings per share might change. What specifically?</p> <p>15 A. That was it, the GAAP statement that I was looking at.</p> <p>16 If you saw a GAAP statement, there's very little</p> <p>17 information -- I mean, it's all consolidated. And net income</p> <p>18 would increase significantly enough to adjust earnings per</p> <p>19 share by a few cents. I don't remember how many cents. It</p> <p>20 was enough for me to start asking how can you have that many</p> <p>21 adjustments to make that happen.</p> <p>22 Q. So this is after EBITDA, if I can put it that way,</p> <p>23 talking about a net number now?</p> <p>24 A. Net number. I didn't deal with EBITDA.</p> <p>25 Q. Now, let's go to the conversations you had with Cathy</p>	<p style="text-align: right;">Page 133</p> <p>1 BY MR. SJOBLUM:</p> <p>2 Q. What is it that you discussed with Ms. Edwards?</p> <p>3 A. It really wasn't a discussion, it was a request that was</p> <p>4 made of me that I refused to do.</p> <p>5 Q. What did she ask you to do?</p> <p>6 A. I was asked to change a balance sheet.</p> <p>7 Q. What on a balance sheet?</p> <p>8 A. I was asked to re-group balance sheet information from</p> <p>9 one category to the next, and I refused to do it.</p> <p>10 Q. What category? An asset, a liability, what?</p> <p>11 A. I believe I was asked to move an asset account to the</p> <p>12 cash account.</p> <p>13 Q. Do you remember what the asset was?</p> <p>14 A. No, I do not.</p> <p>15 Q. Do you remember the dollar size of it?</p> <p>16 A. It was not a dollar amount. It was to change the</p> <p>17 statement itself, to change the reporting of the statement so</p> <p>18 that the statement reflected numbers differently.</p> <p>19 Q. If I understand, you're saying some kind of fixed asset,</p> <p>20 going to turn that into a cash, is that what you're saying?</p> <p>21 A. They asked me to take an asset account and take it out of</p> <p>22 the asset line item and move it to what I believe to be the</p> <p>23 cash account, line item on the balance sheet.</p> <p>24 THE COURT: How would it show up there? I mean</p> <p>25 what -- how were you supposed to list it?</p>

<p style="text-align: right;">Page 134</p> <p>1 THE WITNESS: I was asked to change the report so                  2 that when they ran the statements, that account no longer                  3 appeared here. It appeared here on the balance sheet.                  4 THE COURT: To show an increase in the cash?                  5 THE WITNESS: I'm sorry?                  6 THE COURT: To show an increase in the cash?                  7 THE WITNESS: Either increase or decrease, whatever                  8 way it would fall.                  9 THE COURT: Okay.                  10 BY MR. SJOBLOM:                  11 Q. Now, this conversation you had with Mr. Livesay where                  12 you're talking about reserves and you're asking him if there                  13 are enough reserves for the changes, who was present at that                  14 conversation?                  15 A. Who was present?                  16 Q. Present?                  17 A. Myself and Ken Livesay.                  18 Q. What exactly did Mr. Livesay say to you when you asked                  19 him about the reserves?                  20 A. Which time?                  21 Q. This is the first one Mr. Loomis referred to. Mid-1998,                  22 I believe.                  23 A. Mid-19 --                  24 THE COURT: '98.                  25 THE WITNESS: Okay. He said -- What was the</p>	<p style="text-align: right;">Page 136</p> <p>1 being reversed and there could have been other reserves.                  2 Those are the two that I --                  3 BY MR. SJOBLOM:                  4 Q. Where does that reserve show up on the financial                  5 statement?                  6 A. The expense of it would show up on your income statement                  7 under operating expenses, and the accrual of it would show up                  8 on your balance sheet, your accrued assets.                  9 Q. Accrued assets or accrued liabilities?                  10 A. Oh god. That's been two years. The accrued liability, I                  11 believe.                  12 Q. The subsequent conversation you say was March '99 to                  13 April '99. This is the second time you talked to Ken Livesay                  14 because you did not believe there's enough reserves?                  15 A. Yes. It continued to have --                  16 Q. Are we still talking about the same reserves?                  17 A. We're just talking about just reserves in general.                  18 Q. What came to your attention in this March '99/April '99,                  19 review that there were not enough reserves?                  20 A. I'm not sure. I don't really recall exactly what                  21 triggered that, but it had been occurring.                  22 THE COURT: Would there have been three more                  23 quarters?                  24 THE WITNESS: That would have been about three more                  25 quarters, year-end. And if it continued to happen at one</p>
<p style="text-align: right;">Page 135</p> <p>1 question? I'm sorry.                  2 BY MR. SJOBLOM:                  3 Q. There was a discussion with Mr. Livesay in mid-'98 when                  4 you asked him whether or not there are enough reserves for                  5 these changes. Two questions: What reserves are you talking                  6 about?                  7 A. When I asked if -- when I asked about the changes, I was                  8 told that they were reverses of reserves.                  9 Q. Reversing --                  10 A. Reversing of reserves. And I asked if there was enough                  11 reverse -- reserves or what reserves they were. And I was                  12 told it was the bonus accrual was being reversed and some                  13 home office.                  14 Q. What is bonus accrual? What is that?                  15 A. Monthly, if you're planning on paying out bonuses, you                  16 can accrue for that expense on a monthly basis and build an                  17 accrual so that when it comes time to pay your bonuses out,                  18 you don't get hit with a huge charge in the month of payment                  19 you have accrued for them. So you build this liability.                  20 THE COURT: It's kind of like a Christmas bonus.                  21 THE WITNESS: Yes. There you go.                  22 THE COURT: And did you have that? Did you have a                  23 bonus account?                  24 THE WITNESS: Yes. Yes. There's bonuses. There's                  25 bonus accruals. And they -- I was just told that that was</p>	<p style="text-align: right;">Page 137</p> <p>1 point, if you had any reserves, you would no longer have                  2 reserves, and E&amp;Y would not allow you to have an                  3 overabundance of reserves in order for you to do that                  4 continually that significantly from quarter to quarter.                  5 BY MR. SJOBLOM:                  6 Q. Now, you say you were called into Mr. Owens' office in                  7 March '99 to April '99. You told Mr. Owens that, if I got it                  8 right, I think you used the word "accused," you accused Mr.                  9 Owens of having fraudulent entries; is that right?                  10 A. Correct.                  11 Q. Who was present?                  12 A. Myself and Mr. Owens.                  13 Q. Can you be more specific as to what you said to Mr.                  14 Owens?                  15 A. That basically I felt like it was fraudulent entries and                  16 that I didn't believe in what was going on and wanted no part                  17 of it.                  18 Q. What was his position at the time?                  19 A. Controller.                  20 Q. And what did he say to you?                  21 A. He said something to the effect that it needed to be                  22 done. You know -- I don't know his words, that the company                  23 could start closing down, you know, if the stock went down or                  24 something to that effect, that it would affect employees and                  25 people could start losing their jobs and that it had to be</p>

<p style="text-align: right;">Page 138</p> <p>1 done.</p> <p>2 Q. So he said he was in control of it; right?</p> <p>3 A. He didn't exactly say those words, no.</p> <p>4 Q. But that's the impression he left you with?</p> <p>5 A. He left me with the impression that he felt like he had</p> <p>6 to do what was going on.</p> <p>7 THE COURT: Did he ever say to you in that</p> <p>8 conversation or did Mr. Livesay ever say to you in the</p> <p>9 previous conversation you had with him, come here, let me</p> <p>10 show you why this is legitimate, let me show you what changes</p> <p>11 have been made and why this occurred?</p> <p>12 THE WITNESS: No.</p> <p>13 BY MR. SJOBLUM:</p> <p>14 Q. Did he offer any explanation other than just that it had</p> <p>15 to be done?</p> <p>16 A. No.</p> <p>17 Q. You accepted that explanation?</p> <p>18 A. No.</p> <p>19 Q. What did you do about it?</p> <p>20 A. I told him that I had a decision to make and I didn't</p> <p>21 know what that decision was going to be at that time, that I</p> <p>22 was not going to sit idly by and watch it.</p> <p>23 Q. And what did you do about it?</p> <p>24 A. I went back to my office and tried to keep an eye on it.</p> <p>25 And again, it only happened quarterly. And by the end of the</p>	<p style="text-align: right;">Page 140</p> <p>1 Q. Do you have your card with you?</p> <p>2 A. It's actually back in the witness room. Yes.</p> <p>3 Q. But you still carry it?</p> <p>4 A. Yes, I do.</p> <p>5 Q. Have you carried it ever since you came to HealthSouth?</p> <p>6 A. I believe they were handed out last year. The actual</p> <p>7 card, I believe.</p> <p>8 Q. Did you attend something called the new officer meeting?</p> <p>9 A. The new officer meeting?</p> <p>10 Q. Yes. Where there is an announcement to people about new</p> <p>11 officers who come on with the company?</p> <p>12 A. There were occasional -- There wasn't a meeting. It was</p> <p>13 more of a little brunch so, you know, these people are now</p> <p>14 officers.</p> <p>15 Q. And you were announced, if you will, as being a new</p> <p>16 officer for the company?</p> <p>17 A. Yes.</p> <p>18 Q. In the midst of those types of -- Did you ever attend any</p> <p>19 other ones, where it wasn't just you, but it was other people</p> <p>20 who were announced?</p> <p>21 A. A couple. One or two maybe.</p> <p>22 Q. In those meetings, do you recall statements being made</p> <p>23 about the need to safeguard the assets of HealthSouth?</p> <p>24 A. Need to safeguard the assets?</p> <p>25 Q. Yes. You are an officer of the company; we expect you to</p>
<p style="text-align: right;">Page 139</p> <p>1 third quarter is when I went to Compliance with my complaint.</p> <p>2 Q. Are you familiar with something called the 1-800 fraud</p> <p>3 line?</p> <p>4 A. 1-800 fraud line?</p> <p>5 Q. Fraud program?</p> <p>6 A. No.</p> <p>7 Q. During any part of your training or coming into</p> <p>8 HealthSouth, were you made aware that there was what is now</p> <p>9 referred to as Sarbanes Oxley, the whistle-blower line? Were</p> <p>10 you aware there was a mechanism for you to make an anonymous</p> <p>11 phone call to an on-site agency and report fraud that was</p> <p>12 going on within a corporation?</p> <p>13 A. No, I really didn't know how to go --</p> <p>14 Q. Did you have a fraud card?</p> <p>15 A. A fraud card?</p> <p>16 Q. A card to be used for that purpose?</p> <p>17 A. The only card I have is for our corporate compliance.</p> <p>18 Q. What was on that corporate compliance card?</p> <p>19 A. I believe it's the 800 number to our corporate</p> <p>20 compliance.</p> <p>21 Q. I'm sorry?</p> <p>22 A. I believe it's the 800 number to our corporate compliance</p> <p>23 line.</p> <p>24 Q. You are still employed at HealthSouth; right?</p> <p>25 A. Yes, I am.</p>	<p style="text-align: right;">Page 141</p> <p>1 act with the highest state of integrity, that there is a code</p> <p>2 of business conduct, there's a code of ethics that we expect</p> <p>3 that type of high level integrity of our officers?</p> <p>4 A. Right.</p> <p>5 Q. Did you hear that type of speech?</p> <p>6 A. I could have. I don't know.</p> <p>7 Q. But you knew, you knew --</p> <p>8 A. Yes.</p> <p>9 Q. -- to do the right thing at the company?</p> <p>10 A. Excuse me?</p> <p>11 Q. You knew you had to do the right thing at the company to</p> <p>12 protect the integrity of the company; right?</p> <p>13 A. Yeah.</p> <p>14 Q. Now, it looks like six or seven months go by and then you</p> <p>15 have a meeting with the compliance officer in October of '99?</p> <p>16 A. October, yeah.</p> <p>17 Q. Carlson, is that who you said?</p> <p>18 A. Cullison.</p> <p>19 Q. Cullison. What was her job?</p> <p>20 A. She was over corporate compliance.</p> <p>21 Q. What do you mean over? Head of compliance?</p> <p>22 A. I'm not exactly sure of her title.</p> <p>23 Q. What does the compliance department do?</p> <p>24 A. My understanding is that's where you go to when you have</p> <p>25 issues, mainly that the company is doing things wrong, it</p>

<p style="text-align: right;">Page 142</p> <p>1 could be construed fraud. That you go to Corporate                  2 Compliance to investigate any wrongdoing.                  3 Q. Now, if I remember the sequence of events, you had                  4 already met with Mr. Owens and told him that you believed                  5 that he was engaged in fraud, there were fraudulent entries                  6 being made at the company; right?                  7 A. Yes, I did.                  8 Q. When you come to Kelly Cullison, you have a conversation                  9 with her about rumors?                  10 A. No. I said that I was very concerned that there were                  11 fraudulent entries being made in accounting.                  12 Q. Yes.                  13 A. That's not rumors. Those are my concerns. Just like I                  14 approached Bill Owens.                  15 Q. Let me clarify. If my notes are correct, Kelly Cullison                  16 said to you that there are rumors about this and rumors only,                  17 that this is the first she had heard about it?                  18 A. I was the first person to actually come through the door                  19 with information on it.                  20 Q. Where is Kelly Cullison in the corporate hierarchy?                  21 A. As far as --                  22 Q. Well, for example --                  23 THE COURT: Just let her finish.                  24 A. I mean, as far as title or where she falls in this                  25 organizational structure?</p>	<p style="text-align: right;">Page 144</p> <p>1 THE COURT: Let me show you this. Just look with me                  2 here. This is Defendants' Exhibit --                  3 THE WITNESS: Yes, ma'am.                  4 THE COURT: Would that be the number?                  5 THE WITNESS: I don't know.                  6 THE COURT: Are you familiar with the compliance hot                  7 line?                  8 THE WITNESS: Yes, I am.                  9 THE COURT: Okay. Well, I think that's what you                  10 were trying to ask about earlier.                  11 And would Cathy Cullison be the one that would actually                  12 be in charge of this?                  13 THE WITNESS: Kelly Cullison. At that time she was                  14 over that, was the director or --                  15 THE COURT: So whether you called or went in person                  16 wouldn't make any difference?                  17 THE WITNESS: No. You could write, call, or go in                  18 person, and I chose to go in person.                  19 THE COURT: All right.                  20 MR. SJOBLOM: Your Honor, if I might ask you if you                  21 could take a break here at some point and ask that she bring                  22 her card in and make that an exhibit, or a copy --                  23 THE COURT: What does your purse look like?                  24 THE WITNESS: A black purse. It's in there in there                  25 in the witness room (pointing) --</p>
<p style="text-align: right;">Page 143</p> <p>1 Q. Falls in the organizational structure.                  2 A. I really don't know where compliance, if it's grouped in                  3 with internal audit or not. I don't even -- I don't know.                  4 THE COURT: When you approached her and said you                  5 were concerned about fraud being committed in the accounting                  6 department, was it her response to you that she had heard                  7 rumors and that you were the first person to come to her?                  8 THE WITNESS: Yes.                  9 THE COURT: What did she say to you, if anything,                  10 about what she would do about it?                  11 THE WITNESS: She said that she -- she asked if I                  12 knew -- how much I was talking about, where it was, who was                  13 involved. I gave her all that information and I actually                  14 told her how she could write some queries to try and find the                  15 information within the system.                  16 THE COURT: And what did she say?                  17 THE WITNESS: She said she would definitely look to                  18 investigate and take it from there.                  19 THE COURT: Okay. Let me ask you something just to                  20 clear it up because I think you were asked about it. The                  21 only card you have right now as an employee of HealthSouth --                  22 THE WITNESS: Yes.                  23 THE COURT: -- is a card with the compliance office                  24 number on it?                  25 THE WITNESS: I believe it's --</p>	<p style="text-align: right;">Page 145</p> <p>1 THE COURT: Go and see if you find a loose purse in                  2 there.                  3 THE WITNESS: It's actually in the front pocket                  4 behind the --                  5 THE COURT: No. She'll give you your purse.                  6 Okay. Anything else?                  7 MR. SJOBLOM: Yes.                  8 THE COURT: Okay. Let's just go on.                  9 BY MR. SJOBLOM:                  10 Q. You also testified that after this meeting with Kelly                  11 Cullison, Mr. Owens said to you that it would stop?                  12 A. Yes.                  13 Q. Where was that conversation?                  14 A. That was in his office.                  15 Q. So there's a second time you were back in his office?                  16 A. Yes.                  17 Q. When?                  18 A. It was around December of '99.                  19 Q. So we're talking then about -- Let's say the last quarter                  20 of 1998 and then all quarters of '99, that's when this was                  21 going on?                  22 A. Yes.                  23 Q. Essentially five quarters?                  24 A. Yes.                  25 Q. And was anybody else present besides you and Mr. Owens?</p>

<p style="text-align: right;">Page 146</p> <p>1 A. No, they were not.                  2 Q. All right.                  3 (Courtroom deputy handing purse to Ms. Henze.)                  4 (Witness giving card to attorney.)                  5 MR. SJOBLOM: Your Honor, I'd like to make Ms.                  6 Henze's card Defendants' Exhibit, I believe, No. 10.                  7 THE COURT: It would be No. 1. There hasn't been a                  8 No. 1 yet.                  9 MR. SJOBLOM: We've got the book.                  10 THE COURT: Yes. Okay. Would you just make a xerox                  11 copy of it? Just make a xerox copy of it so she can get her                  12 card back.                  13 MR. SJOBLOM: Yes. Let me, just for identification                  14 purposes, Defendants' Exhibit No. 10, a black and white card                  15 with a red box in the middle that says, "Pulling the Wagon,                  16 Integrity in Action." On the backside, compliance hot line                  17 with the phone number. It says you may also write or fax,                  18 and it has the HealthSouth compliance office.                  19 THE COURT: It would be much easier if you just go                  20 and have one of these gentlemen or lady make a copy of it,                  21 bring the copy in here, mark a copy as your No. 10 and that                  22 will be admitted. Thank you. They can use my office.                  23 MR. SJOBLOM: Thank you.                  24 THE COURT: The original is not marked, right? Get                  25 the copy marked, and you can get yours back.</p>	<p style="text-align: right;">Page 148</p> <p>1 stopped, and it's going to stop the first part of 2000, it's                  2 going to be reversed out. I have no problems having a third                  3 assistant controller, and you will be promoted at that time.                  4 Q. Are you a CPA?                  5 A. No, I'm not.                  6 Q. Did that have anything to do with whether or not you got                  7 the promotion?                  8 A. No.                  9 Q. Now, then you say you were transferred to the internet                  10 group?                  11 A. I was transferred to ITG.                  12 THE COURT: What does that stand for?                  13 THE WITNESS: Information Technology Group.                  14 THE COURT: Okay.                  15 BY MR. SJOBLOM:                  16 Q. When did that occur?                  17 A. I believe it occurred early January, December '99,                  18 somewhere in that time frame.                  19 THE COURT: Early January of 2000?                  20 THE WITNESS: Of 2000. It was shortly after the                  21 conversation I had with Bill Owens in his office.                  22 BY MR. SJOBLOM:                  23 Q. What were your duties at the IT Group?                  24 A. Actually, I didn't have a lot of duties. I was just kind                  25 of transferred there. I asked for a transfer. And then the</p>
<p style="text-align: right;">Page 147</p> <p>1 BY MR. SJOBLOM:                  2 Q. Now, this conversation with Mr. Owens about the fraud                  3 would be stopped --                  4 A. Uh-huh.                  5 Q. -- where was this conversation?                  6 A. In his office.                  7 Q. And what specifically did you say to him?                  8 A. It came in in my inquiry as to why I did not get a                  9 promotion to assistant controller.                  10 Q. Okay. And his response to you was because you didn't do                  11 what we asked you to do, is that correct?                  12 A. Yes.                  13 Q. You wouldn't participate in the fraud, right?                  14 A. You wouldn't participate -- Well, he didn't say fraud.                  15 He just said you wouldn't participate.                  16 Q. In what?                  17 A. He said that -- I'm sorry?                  18 Q. In what? You wouldn't participate in --                  19 A. You wouldn't do what we wanted -- what we asked you to                  20 do.                  21 Q. Was there just an understanding between the two of you                  22 what that was?                  23 A. I took it as an understanding because my comment was,                  24 well, if that was your reason, then that's fine that I didn't                  25 get the promotion. He also said that when everything</p>	<p style="text-align: right;">Page 149</p> <p>1 next day I was transferred, and I had no specific duties.                  2 Within -- I don't know, I was asked to help them help train                  3 the accountants on how to file a 10-K. So that's where I                  4 spent the first part of my time is telling them what                  5 schedules needed to be done and the timing of them and how                  6 to -- what information went into the schedule. So for the                  7 first three months of being in IT, I was helping them                  8 understand the 10-K process.                  9 Q. So there was an interrelationship, if I might, between                  10 the accounting staff, the assistant controller, and the IT                  11 Group?                  12 A. No. Basically I was the one familiar with the 10-K since                  13 Ken Livesay was no longer there, as well. And I was helping                  14 them understand what the files were and where they needed to                  15 go next on the 10-K.                  16 Q. Just for simplistic purposes, the IT Group, the                  17 department that generates the document that looks like the                  18 10-K, collects all the information from all the departments?                  19 A. That's accounting.                  20 Q. What does the IT Group do with the 10-K?                  21 A. Nothing. I was helping them out. I was transferred ir                  22 ITG. And because I had experience in preparing 10-K's                  23 asked to help get the 10-K filed. So I was helping thr                  24 people who were basically to become responsible fr                  25 helping them understand the schedules, what info</p>

<p style="text-align: right;">Page 150</p> <p>1 into the schedule.                  2 Q. What do you mean by helping them be responsible for the                  3 10-K?                  4 A. I was helping them. The people who are now responsible                  5 for that had no experience in those reports.                  6 Q. In doing what?                  7 A. In preparing the documents.                  8 Q. Are you talking about the document, are you talking about                  9 the figures, are you talking about the schedules, the hard                  10 paper, the computer program? What are you talking about?                  11 A. The schedules that went into the 10-K documentation.                  12 THE COURT: In other words, it was just a pro forma                  13 transfer. You were still helping out with the new people who                  14 were preparing the 10-Ks?                  15 THE WITNESS: Because they had no knowledge of --                  16 THE COURT: Where was Mr. Livesay?                  17 THE WITNESS: He was the CIO now, running --                  18 THE COURT: Okay.                  19 MR. SJOBLOM: Do what?                  20 THE WITNESS: He was the CIO at this point.                  21 BY MR. SJOBLOM:                  22 Q. Now, let's go back kind of at the beginning and let me                  23 sit down. And I know you want to get off the witness stand.                  24 If I understand the process of your involvement as                  25 Assistant VP and Vice President of Finance, you received</p>	<p style="text-align: right;">Page 152</p> <p>1 THE WITNESS: Who got bonuses?                  2 THE COURT: Uh-huh. At HealthSouth. From the                  3 reserves that were set aside.                  4 THE WITNESS: I'm not familiar with the actual                  5 individuals who got bonuses.                  6 THE COURT: You don't know of any?                  7 THE WITNESS: I know that -- I believe bonuses were                  8 paid out. I believe I actually got a bonus.                  9 THE COURT: Okay. Do you have any idea -- Can you                  10 name anyone who got bonuses those years?                  11 THE WITNESS: I can only assume. I don't know                  12 directly.                  13 THE COURT: Okay. Do you know when the 10-Ks were                  14 prepared, the signatures, how they were put together?                  15 THE WITNESS: How the 10-Ks were prepared? Very                  16 similarly to the 10-Qs.                  17 THE COURT: Was there a separate signature page?                  18 THE WITNESS: I don't know. My involvement in the                  19 10-Ks was more of just putting the schedules together.                  20 THE COURT: Do you know whether or not Mr. Scrusby                  21 had an open door policy?                  22 THE WITNESS: I've never tried to go and see Mr.                  23 Scrusby.                  24 THE COURT: Was there a document such as the one                  25 that's been marked as Exhibit No. 5, "Pulling the Wagon"?</p>
<p style="text-align: right;">Page 151</p> <p>1 consolidated figures where the numbers had been determined --                  2 to be accurate, worked through, and you're presented with a                  3 final consolidated figure; right?                  4 A. They worked through all the numbers. And they're ready                  5 to get the consolidated number to them, and I would go                  6 through the process of consolidating it, printing it off and                  7 handing it to them.                  8 Q. When you look at that consolidated figure, and having it                  9 in front of you on the document, can you tell by looking at                  10 that consolidated figure that there is any fraud going on?                  11 A. No. Not to just look at that piece of paper.                  12 Q. Are you familiar with something called "the family"?                  13 A. No. Only what I've read in the paper.                  14 Q. Okay.                  15 MR. SJOBLOM: I have no further questions, Your                  16 Honor. Thank you.                  17 THE COURT: Are you going to mark and offer Exhibit                  18 10?                  19 MR. SJOBLOM: Yes. When we get the document.                  20 THE COURT: It's already made.                  21 Well, I'm going to ask some questions while you're                  22 waiting.                  23 MR. SJOBLOM: Thank you.                  24 THE COURT: Are you familiar with who got bonuses in                  25 1998 and '99?</p>	<p style="text-align: right;">Page 153</p> <p>1 Are you familiar with that document?                  2 THE WITNESS: Yes, ma'am.                  3 THE COURT: Is there anything in "Pulling the Wagon"                  4 that says if you really want to pull the wagon, go see Mr.                  5 Scrusby?                  6 THE WITNESS: Don't know.                  7 THE COURT: Okay. Do you feel like you could have                  8 gone to see Mr. Scrusby about the fraud that you thought was                  9 going on in the accounting department?                  10 THE WITNESS: Do I feel like I could have gone to                  11 him?                  12 THE COURT: Yes.                  13 THE WITNESS: No.                  14 BY MR. SJOBLOM:                  15 Q. Why not? Why did you feel you couldn't go see Mr.                  16 Scrusby?                  17 A. Personally, intimidation.                  18 Q. You would feel personally intimidated?                  19 A. The intimidation factor and the fear factor.                  20 Q. Because he's CEO and you're an Assistant VP of Finance?                  21 A. No. It's just a presence and a feeling and rumor.                  22 That's my personal hearing of rumors.                  23 Q. Prior to the time you took the job as Assistant VP of                  24 Finance, who had your job?                  25 A. I don't believe anybody had that job -- Wait. Before I</p>

<p style="text-align: right;">Page 154</p> <p>1 got there or before I was promoted to that position?                  2 Q. The person who occupied the position prior to you as                  3 Assistant VP of Finance?                  4 A. Again, there are several Assistant Vice Presidents of                  5 Finance that held different responsibilities.                  6 Q. How many?                  7 A. Anybody in finance, like asset management, there was vice                  8 president of assets and payroll, accounts payable, general                  9 accounting. They could all have that same title. But as far                  10 as my responsibilities and duties as Assistant Vice President                  11 of Finance, my duties did not change. When I first got to                  12 HealthSouth, that's what I was doing, the same                  13 responsibilities and promoted to that title. No change in                  14 responsibilities.                  15 Q. How many assistant VPs of finance were there?                  16 A. At the time that I was Assistant Vice President of                  17 Finance, I believe Emery Harris was assistant -- was promoted                  18 to Assistant Vice President at the same time. Lisa Byrd was                  19 Assistant Vice President at that time or promoted at that                  20 time. I think the three of us all got promoted to Assistant                  21 Vice Presidents of Finance at the same time. I really don't                  22 know everybody else at that time.                  23 Q. Mr. Bennett was President when you were Assistant VP of                  24 Finance?                  25 THE COURT: Mr. Bennett was what?</p>	<p style="text-align: right;">Page 156</p> <p>1 statement.* Would that be an e-mail message?                  2 A. That would be an e-mail message, but the consolidation                  3 was within the system.                  4 Q. You go into the network, call up the statement, make the                  5 changes, and override the prior number?                  6 A. I never made any changes. I would re-run the                  7 consolidations.                  8 THE COURT: What I understood you to say, I didn't                  9 think you made any changes --                  10 THE WITNESS: I didn't make any changes.                  11 THE COURT: -- they would ask you to reopen the                  12 period?                  13 THE WITNESS: Yes.                  14 MR. SJOBLOM: Right.                  15 THE COURT: Then they would tell you when you could                  16 re-do the consolidation?                  17 THE WITNESS: Correct.                  18 THE COURT: And when you put that in the software                  19 program, you came up with different numbers that you then                  20 questioned?                  21 THE WITNESS: Correct.                  22 THE COURT: But you never made any changes?                  23 THE WITNESS: I did not make any changes.                  24 THE COURT: Okay.                  25 BY MR. SJOBLOM:</p>
<p style="text-align: right;">Page 155</p> <p>1 MR. SJOBLOM: President.                  2 THE COURT: Of what?                  3 MR. SJOBLOM: HealthSouth.                  4 THE COURT: Okay.                  5 A. He could have been. He was president when I was there                  6 and an officer. I'm not sure of the time, his actual years                  7 of service.                  8 Q. Did you keep any of the reports or documents on which you                  9 made these changes?                  10 A. That I made changes?                  11 Q. When you were asked to reopen, make adjustments, revoke                  12 any of the documentation, is there any documentation that                  13 reflects how that process happened?                  14 A. No. It's all on a system. You flip a switch.                  15 Q. It's on the computer?                  16 A. It's on the computer.                  17 Q. So once you made the change, you don't know where it came                  18 from, how it originated? It's now just a new consolidated                  19 number?                  20 A. It's a new consolidated number. The ones prior to that,                  21 I did not keep.                  22 Q. And the way you get this information is a -- you're on                  23 the land, you do it, or you just get this information by                  24 e-mails? For example, I type you an e-mail and say, "Ms.                  25 Henze, make the following changes on the new consolidated</p>	<p style="text-align: right;">Page 157</p> <p>1 Q. Were there e-mail messages sent to you by anyone what                  2 changes to be made -- Strike that.                  3 The e-mail messages regarding that topic, this process?                  4 THE COURT: Are you asking her whether or not she                  5 got an e-mail message from somebody saying to reopen the                  6 period?                  7 MR. SJOBLOM: Yes.                  8 THE COURT: That would be the only thing you would                  9 have gotten notified about; wouldn't it?                  10 THE WITNESS: Yes. That would be it, but it was                  11 mostly by phone.                  12 BY MR. SJOBLOM:                  13 Q. Who made those phone calls?                  14 A. It could be Emery Harris. It could be Kay Morgan. It                  15 could be one of the senior accountants when they were                  16 finished. I mean, one of the managers in general accounting.                  17 THE COURT: Would that be the same people that would                  18 have called you up earlier and said, we're ready, we're                  19 finished --                  20 THE WITNESS: Yes.                  21 THE COURT: Did you ever question them about --                  22 THE WITNESS: I would get very frustrated and                  23 aggravated and ask what kind of entries, what are you guys                  24 doing? And it's like, we just have some adjustments.                  25 BY MR. SJOBLOM:</p>

<p style="text-align: right;">Page 158</p> <p>1 Q. This is Emery Harris and Kay Morgan you would say that 2 to, "What are you guys doing?" 3 A. It could be those. It could just be the accounting 4 managers. It wasn't just one person, but it was usually with 5 somebody who was either a manager, senior accountant, Emery 6 or Kay. 7 Q. Kay? Kay Morgan? 8 A. Kay Morgan. I'm sorry. 9 Q. Did you ever make any notes about these phone 10 conversations? 11 A. No. 12 Q. Did you ever provide the SEC or the U. S. attorney's 13 office any documents or any type of information regarding 14 what you are talking about here today, other than oral -- 15 A. No. 16 Q. -- discussions? 17 A. No. 18 MR. SJOBLUM: I have no further questions, Your 19 Honor. Thank you. 20 THE COURT: Okay. 21 REDIRECT EXAMINATION 22 BY MR. LOOMIS: 23 Q. I just have a few questions on redirect. 24 To your knowledge, was any action taken by any 25 HealthSouth employee after you made your complaint to the</p>	<p style="text-align: right;">Page 160</p> <p>1 MR. LOOMIS: It goes to her state of mind, Your 2 Honor. She testified one of the reasons why she didn't want 3 to talk to -- 4 THE COURT: Were the rumors within HealthSouth? 5 THE WITNESS: Yes. 6 THE COURT: Overrule the objection. 7 BY MR. LOOMIS: 8 Q. In your discussions that you had with Mr. Livesay, did 9 you ever talk to him about his moving to chief information 10 officer? 11 A. Did I talk to him about him moving? 12 Q. Transferring? 13 A. About him personally moving? 14 Q. Yes. 15 A. He just kind of was moved, and I was told about it then. 16 Q. I'm sorry? 17 A. He was just kind of -- I found out he was transferring 18 when he transferred. I didn't know that that was even 19 coming. 20 Q. He never talked to you about the reasons why he might 21 want to transfer? 22 A. No. Not that he would transfer. 23 MR. LOOMIS: No further questions. 24 RECROSS EXAMINATION 25 BY MR. SJOBLUM:</p>
<p style="text-align: right;">Page 159</p> <p>1 Compliance Department? 2 A. I don't understand the question. 3 Q. Any action taken in response to your complaint that you 4 made to the Compliance? 5 A. I was asked was anything -- was anything ever done based 6 on -- Not to my knowledge. I mean, I know that it went up to 7 Tony Tanner, who went to Mike Martin, who called Bill Owens 8 and Ken Livesay about my inquiry or my accusation, however 9 is. And Ken talked to me and said that they wanted me to 10 come back and talk to him about it. And I just said, I have 11 nothing else to say. That's all the knowledge I have that 12 took place. 13 Q. In response to the questions by the judge, you mentioned 14 that one reason why you didn't want to talk to Mr. Scrusby 15 was because of rumors; is that correct? 16 A. Yes. Just the atmosphere. 17 Q. Well, can you articulate a little bit about what those 18 rumors were, your understanding of them? 19 A. That basically you could easily be terminated if you 20 brought bad news, stuff he didn't want to hear about. 21 MR. SJOBLUM: Object, Your Honor. I move to strike. 22 It sounds like we're in a hearsay area. I don't know where 23 these rumors are coming from. It sounds like something she 24 can't put a person behind. I would move to strike as 25 hearsay.</p>	<p style="text-align: right;">Page 161</p> <p>1 Q. Ms. Henze, did anyone ever instruct you that you could 2 not go to Mr. Scrusby and report this? 3 A. No. 4 Q. Did Mr. Owens ever say to you, I will take care of it, go 5 back and do your job? 6 A. He never really said that either. 7 Q. Did he do anything to discourage you from going to Mr. 8 Scrusby? 9 A. No, he did not. 10 THE COURT: But he said to you it was stopping? 11 THE WITNESS: Yes, he did. 12 THE COURT: And to your knowledge, did it stop? 13 THE WITNESS: I have no direct knowledge whether it 14 continued or whether it stopped. I was out of accounting -- 15 THE COURT: Okay. 16 THE WITNESS: -- shortly after that. 17 MR. LOOMIS: I have no further questions, Your 18 Honor. 19 MR. SJOBLUM: Nothing further, Your Honor. 20 Thank you. 21 THE COURT: You are excused. 22 Where is her card? 23 MR. SJOBLUM: I returned it to her, I believe. 24 THE COURT: You have it. That's good. Do you have 25 your purse?</p>

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<p>1 THE WITNESS: Yes, ma'am.</p> <p>2 THE COURT: Thank you, ma'am. You can go. Call</p> <p>3 your next witness.</p> <p>4 MR. LOOMIS: Teresa Sanders.</p> <p>5 TERESA SANDERS</p> <p>6 was sworn/affirmed and testified as follows:</p> <p>7 BY THE COURTROOM DEPUTY:</p> <p>8 Q. State your full name for the record.</p> <p>9 A. It's Teresa Rubio Sanders.</p> <p>10 Q. Would you spell Teresa?</p> <p>11 A. T-e-r-e-s-a. Rubio is R-u-b-i-o. Sanders,</p> <p>12 S-a-n-d-e-r-s.</p> <p>13 Q. The city and the state where you live?</p> <p>14 A. Birmingham, Alabama.</p> <p>15 DIRECT EXAMINATION</p> <p>16 BY MR. LOOMIS:</p> <p>17 Q. Ms. Sanders, where are you currently employed?</p> <p>18 A. At Eastern Health System.</p> <p>19 Q. Where is that?</p> <p>20 A. That is out at Medical Center East here in Birmingham.</p> <p>21 Q. Can you describe the business of Eastern Health Services?</p> <p>22 A. They own three hospitals, a nursing home, physician</p> <p>23 clinics, and Eastern Health System is the corporate office.</p> <p>24 Q. And how long have you been employed at Eastern Health</p> <p>25 Services?</p>	<p>1 internal auditor until three years, was promoted after a year</p> <p>2 of employment to Assistant Vice President of Internal Audit.</p> <p>3 A few years later I was promoted to Vice President. And when</p> <p>4 I left the company, I was Group Vice President and Chief</p> <p>5 Auditing Officer.</p> <p>6 Q. As an internal auditor in your various roles, who did you</p> <p>7 report directly to at HealthSouth?</p> <p>8 A. To Richard Scrusby.</p> <p>9 Q. And did you have responsibilities for the internal audit</p> <p>10 function at HealthSouth?</p> <p>11 A. Yes, I did.</p> <p>12 Q. Let's get a little bit of background. Do you have a</p> <p>13 college degree?</p> <p>14 A. Yes, I do.</p> <p>15 Q. Tell us about that.</p> <p>16 A. I graduated from the University of Alabama with a</p> <p>17 bachelor's in accounting as well as a master's in</p> <p>18 accountancy.</p> <p>19 Q. When did you receive your master's?</p> <p>20 A. In 1988.</p> <p>21 Q. And when did you receive your undergraduate degree?</p> <p>22 A. In 1986.</p> <p>23 Q. Are you a CPA?</p> <p>24 A. Yes, I am.</p> <p>25 Q. Are you a member of any professional accounting</p>
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<p>1 A. Since January of 2000.</p> <p>2 Q. And what is your title there?</p> <p>3 A. Vice President and Compliance Officer.</p> <p>4 Q. Are you familiar with the phrase "internal audit</p> <p>5 function"?</p> <p>6 A. Yes, I am.</p> <p>7 Q. Describe for me what that is.</p> <p>8 A. In layman's terms, Internal Audit reviews the financial</p> <p>9 records and the operations of a company based on the policies</p> <p>10 and procedures that are set up by management.</p> <p>11 Q. What is the purpose for the review of these financial</p> <p>12 statements?</p> <p>13 A. To make sure that they are operating in accordance to the</p> <p>14 policies and procedures.</p> <p>15 Q. Do you have any internal audit functions in your position</p> <p>16 with Eastern Health Services?</p> <p>17 A. Yes, I do.</p> <p>18 Q. Where were you employed prior to Eastern Health Services?</p> <p>19 A. With HealthSouth Corporation.</p> <p>20 Q. Can you give us the dates of your employment with</p> <p>21 HealthSouth?</p> <p>22 A. Yes. Between March of 1990 and November of 1999.</p> <p>23 Q. Can you tell us the various positions you had at</p> <p>24 HealthSouth?</p> <p>25 A. I was hired as the internal auditor, was the only</p>	<p>1 associations?</p> <p>2 A. Yes. American Institute of CPAs, the Institute of</p> <p>3 Internal Auditors, and the Association of Certified Fraud</p> <p>4 Examiners.</p> <p>5 Q. And did you have a job prior to -- after leaving college</p> <p>6 and before joining HealthSouth?</p> <p>7 A. Yes. With Ernst &amp; Young.</p> <p>8 Q. What was your position with Ernst &amp; Young?</p> <p>9 A. I was a staff accountant.</p> <p>10 Q. Now, at Eastern Health, as part of your responsibilities</p> <p>11 in the internal audit function, do you meet with the audit</p> <p>12 committee?</p> <p>13 A. Yes, I do.</p> <p>14 Q. Is that an important part to fulfill your job</p> <p>15 responsibilities?</p> <p>16 A. Yes, it is, very.</p> <p>17 Q. And do you have any direct reporting relationship with</p> <p>18 the audit committee at Eastern Health?</p> <p>19 A. Yes. I report directly to the audit committee as well as</p> <p>20 to the CEO of Eastern Health System.</p> <p>21 Q. Is that important for you to fulfill your obligations in</p> <p>22 the internal audit function?</p> <p>23 A. Yes, it is.</p> <p>24 Q. Does Eastern Health maintain a set of books or accounting</p> <p>25 books for the corporation?</p>

<p style="text-align: right;">Page 162</p> <p>1 THE WITNESS: Yes, ma'am.                  2 THE COURT: Thank you, ma'am. You can go. Call                  3 your next witness.                  4 MR. LOOMIS: Teresa Sanders.                  5 TERESA SANDERS                  6 was sworn/affirmed and testified as follows:                  7 BY THE COURTROOM DEPUTY:                  8 Q. State your full name for the record.                  9 A. It's Teresa Rubio Sanders.                  10 Q. Would you spell Teresa?                  11 A. T-e-r-e-s-a. Rubio is R-u-b-i-o. Sanders,                  12 S-a-n-d-e-r-s.                  13 Q. The city and the state where you live?                  14 A. Birmingham, Alabama.                  15 DIRECT EXAMINATION                  16 BY MR. LOOMIS:                  17 Q. Ms. Sanders, where are you currently employed?                  18 A. At Eastern Health System.                  19 Q. Where is that?                  20 A. That is out at Medical Center East here in Birmingham.                  21 Q. Can you describe the business of Eastern Health Services?                  22 A. They own three hospitals, a nursing home, physician                  23 clinics, and Eastern Health System is the corporate office.                  24 Q. And how long have you been employed at Eastern Health                  25 Services?</p>	<p style="text-align: right;">Page 164</p> <p>1 internal auditor until three years, was promoted after a year                  2 of employment to Assistant Vice President of Internal Audit.                  3 A few years later I was promoted to Vice President. And when                  4 I left the company, I was Group Vice President and Chief                  5 Auditing Officer.                  6 Q. As an internal auditor in your various roles, who did you                  7 report directly to at HealthSouth?                  8 A. To Richard Scrusby.                  9 Q. And did you have responsibilities for the internal audit                  10 function at HealthSouth?                  11 A. Yes, I did.                  12 Q. Let's get a little bit of background. Do you have a                  13 college degree?                  14 A. Yes, I do.                  15 Q. Tell us about that.                  16 A. I graduated from the University of Alabama with a                  17 bachelor's in accounting as well as a master's in                  18 accountancy.                  19 Q. When did you receive your master's?                  20 A. In 1988.                  21 Q. And when did you receive your undergraduate degree?                  22 A. In 1986.                  23 Q. Are you a CPA?                  24 A. Yes, I am.                  25 Q. Are you a member of any professional accounting</p>
<p style="text-align: right;">Page 163</p> <p>1 A. Since January of 2000.                  2 Q. And what is your title there?                  3 A. Vice President and Compliance Officer.                  4 Q. Are you familiar with the phrase "internal audit                  5 function"?                  6 A. Yes, I am.                  7 Q. Describe for me what that is.                  8 A. In layman's terms, Internal Audit reviews the financial                  9 records and the operations of a company based on the policies                  10 and procedures that are set up by management.                  11 Q. What is the purpose for the review of these financial                  12 statements?                  13 A. To make sure that they are operating in accordance to the                  14 policies and procedures.                  15 Q. Do you have any internal audit functions in your position                  16 with Eastern Health Services?                  17 A. Yes, I do.                  18 Q. Where were you employed prior to Eastern Health Services?                  19 A. With HealthSouth Corporation.                  20 Q. Can you give us the dates of your employment with                  21 HealthSouth?                  22 A. Yes. Between March of 1990 and November of 1999.                  23 Q. Can you tell us the various positions you had at                  24 HealthSouth?                  25 A. I was hired as the internal auditor, was the only</p>	<p style="text-align: right;">Page 165</p> <p>1 associations?                  2 A. Yes. American Institute of CPAs, the Institute of                  3 Internal Auditors, and the Association of Certified Fraud                  4 Examiners.                  5 Q. And did you have a job prior to -- after leaving college                  6 and before joining HealthSouth?                  7 A. Yes. With Ernst &amp; Young.                  8 Q. What was your position with Ernst &amp; Young?                  9 A. I was a staff accountant.                  10 Q. Now, at Eastern Health, as part of your responsibilities                  11 in the internal audit function, do you meet with the audit                  12 committee?                  13 A. Yes, I do.                  14 Q. Is that an important part to fulfill your job                  15 responsibilities?                  16 A. Yes, it is, very.                  17 Q. And do you have any direct reporting relationship with                  18 the audit committee at Eastern Health?                  19 A. Yes. I report directly to the audit committee as well as                  20 to the CEO of Eastern Health System.                  21 Q. Is that important for you to fulfill your obligations in                  22 the internal audit function?                  23 A. Yes, it is.                  24 Q. Does Eastern Health maintain a set of books or accounting                  25 books for the corporation?</p>

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<p>1 A. Yes, they do.                  2 Q. Does it maintain a separate set of books for various                  3 facilities?                  4 A. Yes, they do.                  5 Q. And do you have access to the corporate accounting books                  6 at Eastern Health?                  7 A. Yes. Both corporate and the field level.                  8 Q. Does Eastern have an accounting software program?                  9 A. Yes, they do.                  10 Q. Do you have access to that accounting software program?                  11 A. Yes. Both the field and corporate level.                  12 Q. And are you allowed access to the accounting records of                  13 the various facilities at Eastern?                  14 A. Yes. Individual hospitals and the physician clinics.                  15 Q. Now, based on your education, your experience as a CPA                  16 and as a former Ernst &amp; Young employee, and as a member of                  17 the Certified Fraud Examiners, could you say whether it's                  18 important for you to have access to the corporate accounting                  19 books to fulfill your obligations as an internal auditor?                  20 A. Yes.                  21 Q. Is it also important for you to have access to the                  22 corporate accounting software?                  23 A. Yes, it is.                  24 Q. Now, at HealthSouth, did HealthSouth maintain a set of                  25 accounting books at the corporate level?</p>	<p>1 Q. Did you have access to the year-to-date numbers for the                  2 various facilities for income?                  3 A. Not for the year-to-date numbers, no.                  4 Q. Did you ever meet with the audit committee while you were                  5 employed at HealthSouth?                  6 A. Not individually, no.                  7 Q. Did you have any direct reporting relationship with                  8 HealthSouth's audit committee?                  9 A. No, I did not.                  10 Q. In your work with Ernst &amp; Young, did you participate in                  11 the audit of any publicly held companies or any companies, I                  12 should say?                  13 A. Not with publicly held companies, no. But -- I'm not                  14 sure if Regions Bank was public at that point in time or                  15 not. I can't remember. But, yes, I did participate on                  16 various audits.                  17 Q. Did the companies that you worked on the audit for, did                  18 they have an internal audit staff?                  19 A. Yes, they did.                  20 Q. Did those internal auditors have access or a direct                  21 reporting relationship to the audit committee?                  22 A. To my knowledge, yes.                  23 Q. Did those internal auditors have access to the corporate                  24 books and records?                  25 A. To my knowledge, yes.</p>
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<p>1 A. Yes, they did.                  2 Q. Did they maintain a set of accounting books at the                  3 various facilities?                  4 A. Yes.                  5 Q. And did the accounting books at the corporate level, did                  6 they reflect a consolidated result of the entire company?                  7 A. Yes.                  8 Q. And did HealthSouth maintain an accounting software                  9 system?                  10 A. Yes.                  11 Q. And you were in the internal audit role at HealthSouth;                  12 is that right?                  13 A. Correct.                  14 Q. Did you have access to the corporate accounting books at                  15 HealthSouth?                  16 A. No, I did not.                  17 Q. Did you have access to the accounting software system,                  18 the corporate accounting software system, at HealthSouth?                  19 A. Not at the corporate level, no.                  20 Q. You said you had access to the accounting records for the                  21 various facilities?                  22 A. Yes.                  23 Q. Did you have access to the income statement for the                  24 various facilities?                  25 A. No, I did not.</p>	<p>1 Q. Did those internal auditors ever meet with the audit                  2 committee, to your knowledge?                  3 A. Yes. I imagine they would.                  4 Q. Did you, while you were employed with HealthSouth, ever                  5 attempt to meet with Mr. Scrushy and talk to him about your                  6 access or lack of access to various information?                  7 A. Yes. I left him messages or left his secretary messages                  8 to get on his calendar and was not able to do so.                  9 MR. LOOMIS: No further questions, Your Honor.                  10 THE COURT: Do you have any questions?                  11 MR. SJOBLOM: I do, Your Honor. If I may have one                  12 moment.                  13 THE COURT: Okay.                  14 (Pause.)                  15 CROSS EXAMINATION                  16 BY MR. SJOBLOM:                  17 Q. Good afternoon. My name is Tom Sjoblom. I represent Mr                  18 Scrushy in this matter.                  19 You have to your left a set of charts. Would you pull                  20 those down, please?                  21 A. (Witness complying.)                  22 Q. The first page, Exhibit No. 2, which is this exhibit, the                  23 first page -- Go back to the first page, this entire Exhibit                  24 2, the first page, the top of it. Is it your understanding                  25 that HealthSouth had a finance and accounting part of the</p>

<p style="text-align: right;">Page 170</p> <p>1 business as well as operations?                  2 A. Yes.                  3 Q. Go to the second page of Exhibit No. 2, which is 2-2,                  4 which is the finance and accounting side of the business for                  5 HealthSouth. You will see a number of directorships as well                  6 as the CFO. You were part of the directorship of Internal                  7 Audit; is that correct?                  8 A. Correct.                  9 Q. And you were in that position, I think you said in that                  10 department, from 1991 --                  11 A. 1990.                  12 Q. Excuse me. March '90 to November '99; is that right?                  13 A. Right.                  14 Q. And in the context of the HealthSouth finance/accounting                  15 side of the corporation, what was the Internal Audit                  16 Department supposed to do for the company?                  17 A. We were not part of the Finance and Accounting                  18 Department. I was hired to audit the facilities.                  19 Q. The operations side?                  20 A. The operations and the finance side of the facilities,                  21 the numbers that they were reporting to the corporate office.                  22 Q. Well, let's go to --                  23 THE COURT: Let me ask you something. Is that                  24 incorrect, then, on Page 2 to show you as part of Finance and                  25 Accounting?</p>	<p style="text-align: right;">Page 172</p> <p>1 to the board of directors.                  2 THE COURT: I'm trying to figure out, did you ever                  3 have an opportunity to be with Mr. Scrusby when you were                  4 reporting otherwise to try to explain to him that you were                  5 unhappy with not having access to the --                  6 MR. SJOBLOM: I object to that, Your Honor. That's                  7 a very leading question to ask if she was unhappy. There's                  8 been no foundation that she ever had that type of                  9 conversation with Mr. Scrusby.                  10 THE COURT: She said that she tried to meet with Mr.                  11 Scrusby about not having access to the corporate level                  12 software. And there was another -- What other corporate                  13 level didn't you have access to? Help me out.                  14 THE WITNESS: Correct. It was any of the corporate                  15 level numbers --                  16 THE COURT: Did I understand you correctly to say                  17 that you tried to meet with Mr. Scrusby about not having                  18 access?                  19 THE WITNESS: Yes.                  20 THE COURT: Did I not understand you to be unhappy                  21 with not having access?                  22 THE WITNESS: I was trying to get access to be able                  23 to do my job, yes.                  24 THE COURT: That's what I thought. So --                  25 MR. SJOBLOM: You're saying for eight years?</p>
<p style="text-align: right;">Page 171</p> <p>1 THE WITNESS: Yes, it is.                  2 THE COURT: Should you be up there parallel to                  3 Finance and Accounting as a separate entity?                  4 THE WITNESS: I did not report to the chief                  5 operating officer. I reported to the CEO of the company.                  6 THE COURT: And that was Mr. Scrusby?                  7 THE WITNESS: That was Mr. Scrusby, yes.                  8 THE COURT: You were not part of Finance and                  9 Accounting?                  10 THE WITNESS: No, ma'am.                  11 THE COURT: So that's not correct?                  12 THE WITNESS: That is not correct.                  13 THE COURT: Okay.                  14 BY MR. SJOBLOM:                  15 Q. You're saying the Internal Audit Department from March                  16 '90 to November '99 had no reporting functions up to the                  17 president; went straight to the CEO?                  18 A. Went directly to the CEO.                  19 Q. It was that way for eight years, nine years?                  20 A. For nine years, correct.                  21 THE COURT: Did you ever get to see Mr. Scrusby,                  22 personally?                  23 THE WITNESS: Well, at our Monday morning meetings                  24 yes, I saw him then. I did not meet with him on a regular                  25 basis, no. I would turn in reports, if I was making a report</p>	<p style="text-align: right;">Page 173</p> <p>1 THE COURT: No. I was asking her a question first,                  2 I do believe. My question to you was: During this                  3 eight-year period when you did not have access to the                  4 corporate level anything, did you ever have an opportunity to                  5 ask Mr. Scrusby when you otherwise met with him about getting                  6 access to this?                  7 THE WITNESS: We didn't have meetings like that.                  8 Basically the only time I ever met with him was when I was                  9 giving my report to the board of directors.                  10 THE COURT: Oh. Okay. That's what I was trying to                  11 find out. You did not have individual one-on-one meetings                  12 with him?                  13 THE WITNESS: The only time that I did have an                  14 individual meeting with him was when we were giving a report                  15 to the board of directors, I would give him the report; and                  16 if he needed to meet with me about that report prior to me                  17 giving it, then, yes, I would meet with him. But that did                  18 not happen very often either.                  19 THE COURT: Did you ever use that opportunity to                  20 tell him, hey, I need access to these corporate level --                  21 THE WITNESS: That was always a very brief meeting.                  22 No, I did not.                  23 THE COURT: Okay.                  24 BY MR. SJOBLOM:                  25 Q. Just so I understand about the groups of meetings that</p>

<p style="text-align: right;">Page 174</p> <p>1 you had. Monday morning meetings, you had reports to the                  2 board, I guess, the audit committee of the board, presenting                  3 the figures --                  4 A. The audit committee meetings were always the full board.                  5 He would stop the meetings and say we're going to have audit                  6 committee meetings now, and the full board would be there.                  7 Q. And then there's this third group of meetings that you                  8 said you were trying to get access to him; right?                  9 A. Correct.                  10 Q. So on these Monday morning meetings, you are making                  11 presentations from the Audit Department about what?                  12 A. The Monday morning meetings were just a report of your                  13 weekly activities. That was given in front of the entire                  14 management team.                  15 Q. Regarding what?                  16 A. Whatever your weekly activities were, the top five things                  17 that you had done over the past week and the five things that                  18 you were trying to do over the next week.                  19 Q. And that happened every week for eight or nine years?                  20 A. Correct.                  21 Q. You're saying that every week, Monday morning, for nine                  22 years, you asked Mr. Scrusy for access to books and records                  23 and he stopped it?                  24 A. That is not what I said. No, sir.                  25 Q. Did you ever raise with him in those Monday morning</p>	<p style="text-align: right;">Page 176</p> <p>1 records and you couldn't get them?                  2 A. Mr. Scrusy hired me to audit the field locations. He                  3 told me that Ernst &amp; Young would be handling corporate.                  4 Q. Now we're talking about something different. We're                  5 talking about what the outside auditors do with respect to                  6 the corporation and what you were doing in the internal audit                  7 department?                  8 A. Correct. And when I was hired, I had very little                  9 experience, and started asking for that when my field                  10 locations -- We had access to the field location                  11 information. Mike Martin turned that information off or                  12 turned our access off.                  13 Q. Mike Martin turned your access --                  14 THE COURT: Wait. Let her finish.                  15 A. At that time is when I started trying to meet with Mr.                  16 Scrusy about the fact that we also not only were having                  17 problems with Mike Martin, but we also didn't have access to                  18 the corporate level books as well.                  19 Q. Who was Mike Martin? What position was he in at that                  20 time?                  21 A. Chief Financial Officer.                  22 Q. During this eight-year time period?                  23 A. Not during the eight-year time period, no, sir. It was                  24 '97 when he became Chief Financial Officer.                  25 Q. Who was the person, the CFO, or controller, or whoever,</p>
<p style="text-align: right;">Page 175</p> <p>1 meetings, I need to see some more records that I'm being                  2 denied access?                  3 A. That is not a forum that you would raise that kind of                  4 question in, sir. No.                  5 Q. Why not?                  6 A. You were only reporting the activities that you had done                  7 the prior week and the current activities that you were going                  8 to be doing the next week.                  9 Q. You are giving the impression to this judge that for nine                  10 years, based on the way Mr. Loomis set this up, it is very                  11 important for the Internal Audit Department to have access to                  12 the corporate records, the corporate accounting books, the                  13 software program; right?                  14 A. Correct.                  15 Q. That's your opinion?                  16 A. Yes.                  17 Q. CPA, AICPA, CFE; right? Correct? That's what you are?                  18 A. Correct, yes.                  19 Q. Prior Ernst &amp; Young audit manager, a part of the audit                  20 team?                  21 A. Correct.                  22 Q. You do a highly critical performance in your business, is                  23 that what you're are saying?                  24 A. Yes.                  25 Q. And you're saying that for nine years, you sought those</p>	<p style="text-align: right;">Page 177</p> <p>1 from March '90 to '97?                  2 A. That would have been Aaron Beam.                  3 Q. Aaron Beam. Did you ever go to Aaron Beam those seven                  4 years and say, I need access to these corporate records?                  5 A. I didn't report to Aaron Beam. So, no, sir, I did not.                  6 Q. Where was Aaron Beam in relation -- he was, what, the                  7 CFO?                  8 A. He was the CFO, yes, sir.                  9 Q. Was he close to you in the building where you were?                  10 A. No, sir, he was not.                  11 Q. Where was his office?                  12 A. In the original building. He was up on the fourth floor                  13 and we were down on the first floor.                  14 Q. So he was three floors away; correct?                  15 A. Correct.                  16 Q. So you're saying that for seven years, this is highly                  17 critical information. The performance of your duties as                  18 chief audit person of the company, you couldn't walk to the                  19 CFO or the controller or the president or the CEO and say I                  20 have to have these books? Is that what you're telling us?                  21 A. In retrospect, sir, yes, sir, I probably should have done                  22 that. But at that point in time, I was very inexperienced                  23 and I did not realize how important it was.                  24 Q. At what point in your career did you decide that this was                  25 important information to have?</p>

<p style="text-align: right;">Page 178</p> <p>1 A. Probably when I started not having access to the 2 financial records. 3 Q. When did that happen? 4 THE COURT: Let her finish. 5 Probably when you didn't have access to what, now? 6 THE WITNESS: When the CFO turned off our access to 7 the field locations, it made me realize that we also did not 8 have access to the corporate level books. 9 THE COURT: That was in 1997? 10 THE WITNESS: That would have been about 1997. 11 BY MR. SJOBLOM: 12 Q. That's Mike Martin, then. He shuts off access? 13 A. Correct. 14 Q. So, it's not Mr. Scrushy who's denying you access; it's 15 Mike Martin denying you access; correct? 16 A. Correct. 17 Q. So during the first four years that you're there, you're 18 too inexperienced, by your own admission, to know what to ask 19 for. But then after you do find out what's important, it's 20 Mike Martin that shuts off your access; right? 21 A. Correct. 22 Q. Did you ask Mr. Martin why he shut off your access? 23 A. Yes, I did. 24 Q. What did you say to him? 25 A. He did not give me an explanation.</p>	<p style="text-align: right;">Page 180</p> <p>1 A. I also made Tony Tanner aware of the problems -- 2 Q. Wait. Let's stay with Mr. Martin first. 3 THE COURT: Hang on just a minute. I think you are 4 confusing something here, Mr. Sjoblom. I don't think I 5 understood you to say that Mike Martin had cut you off from 6 corporate -- 7 THE WITNESS: Correct. 8 THE COURT: -- he just cut you off from the field? 9 THE WITNESS: Correct. We never had access to the 10 corporate level, no. 11 THE COURT: So sometime after 1997 when he cut you 12 off from the field, you talked to him both about that and 13 about not having access to corporate? 14 THE WITNESS: To corporate, yes. 15 BY MR. SJOBLOM: 16 Q. And just to pick up on Your Honor's question, when you're 17 talking about field, you're talking about on the operations 18 side? 19 A. I'm talking about the individual hospitals, the rehab 20 clinics, the surgery centers. 21 Q. Right. Individual facilities? 22 A. Correct. 23 Q. You were looking for the books and records for each of 24 those individual facilities? 25 A. Correct. That is what I was hired to do.</p>
<p style="text-align: right;">Page 179</p> <p>1 Q. How many times did you ask? 2 THE COURT: Mr. Sjoblom? 3 MR. SJOBLOM: Yes. 4 THE COURT: You have got to, first of all, slow 5 down. You've got to let the witness answer the question, and 6 you've got to let the court reporter write it down, and then 7 you ask your next question. So just take it easy on both of 8 these ladies. 9 MR. SJOBLOM: I'll slow down. I apologize. 10 THE COURT: All right. 11 BY MR. SJOBLOM: 12 Q. Let's go back to the point in time when Mike Martin shuts 13 off the access. How many times did you talk to him about you 14 not having access to the corporate books and the corporate 15 software? 16 A. I recall having two conversations with Mike Martin on 17 that. 18 Q. Over a four-year period of time, two? 19 A. Uh-huh. 20 THE COURT: She left in '99. That's a two-year 21 period. 22 THE WITNESS: It would have been a two-year period, 23 yes, ma'am. 24 BY MR. SJOBLOM: 25 Q. Over a two-year period of time, you tried twice?</p>	<p style="text-align: right;">Page 181</p> <p>1 Q. So, let's go back -- Let's go to chart No. 3 -- Exhibit 2 No. 2, Page 3, which is Operations. Do you see that page? 3 A. Correct. 4 Q. 1800 facilities, 1800 people in management. Do you see 5 that? 6 A. Yes. 7 Q. Okay. Now, this is a representation of the three 8 divisions within the company HealthSouth. Do you recognize 9 that? 10 A. Yes. 11 Q. Now, your job is to, from the Internal Audit Department, 12 look across the company into the facilities, each of the 13 facilities of the company and audit those books? 14 A. Yes. 15 Q. So your job really isn't to audit corporate records; it's 16 the field side, the operations side, of the business? 17 A. That's what Richard hired me to do, yes. 18 Q. Okay. So that's what you're supposed to do from March 19 '90 to 1997. This is field operations; right? 20 A. Correct. 21 Q. Then in 1990 to 1997, you say to Mike Martin, by the way, 22 it now has become apparent to me that I need the corporate 23 books as well as the field operation books; is that right? 24 A. I didn't use that exact terminology, but yes -- 25 Q. Well, I understand that at some point in time in your</p>

<p style="text-align: right;">Page 182</p> <p>1 career when you realized the importance of it, you went to 2 Mike Martin? 3 A. Correct. 4 Q. Mike Martin shut it off? 5 A. Mike Martin shut off our access to the field. That is 6 what initiated the conversation about -- 7 Q. Let's back up a minute. What did Mike Martin say to you 8 about why he shut you off from the field operations? 9 A. He said we didn't need it. 10 THE COURT: Did you argue with him about it? 11 THE WITNESS: Yes, I did. We had a couple of 12 arguments about that, yes. 13 BY MR. SJOBLOM: 14 Q. What was Mike Martin's position at the time? 15 A. He was the CFO. 16 Q. The CFO. So the CFO on the finance side, as you just 17 indicated, my chart maybe is not accurate, at least four 18 other entities -- reimbursement, CFO, treasury, tax -- their 19 finance and internal audit is more of an independent 20 function, is that what you're saying? 21 A. Correct. 22 Q. Okay. So, you go to Mike Martin in 1997 and say, I need 23 the field books, or the books for the facilities out in the 24 field, but I'd also like to see the corporate books. That is 25 the main part of the corporation; correct?</p>	<p style="text-align: right;">Page 184</p> <p>1 corporate level. 2 THE WITNESS: No, Mike Martin was the CFO for the 3 entire corporation. 4 BY MR. SJOBLOM: 5 Q. He's got the whole enchilada. I guess that's not 6 appropriate English. But he oversees the whole corporate 7 structure. As a matter of fact, if we go to -- He is the 8 finance department. He is collecting all the data, revenue, 9 payables, collectables -- 10 A. He would be responsible for all those areas, yes. 11 Q. So for some reason, 1997 Mike Martin shuts it down; 12 right? 13 A. He shuts down access to the field, yes. 14 Q. And who is president at this time? 15 A. Jim Bennett. 16 Q. Did you go to Mr. Bennett and say, how come I can't have 17 access to the field records? 18 A. No, sir. 19 Q. Who did you go to try to get access to carry out your 20 duties as the internal auditor of the company to get access 21 to the field records, other than Mike Martin? 22 A. Other than Mike Martin, I tried to get with Richard to 23 let him know, and then I also met with Tony Tanner. 24 Q. Who is Tony Tanner? 25 A. Tony Tanner was an executive vice president and also the</p>
<p style="text-align: right;">Page 183</p> <p>1 A. Correct. 2 Q. Mike Martin shuts it off? 3 Yes? 4 A. He shuts off -- he had shut it off before I even had that 5 conversation with him, yes. 6 Q. So, he is operating within the context of what's 7 happening in finance and accounting; correct? 8 A. Correct. 9 Q. And internal audit is independent of that and he doesn't 10 want you to have access to what's happening over here in the 11 finance and accounting side of the business; correct? 12 A. Correct. 13 Q. Are you aware that in the allegation in this case that 14 the fraud is occurring over in the general accounting 15 office? Are you aware of that? 16 A. I'm aware of it. I've read the complaint, yes. 17 Q. Then from 1997 until you leave, you are being shut off as 18 the internal auditor from that side of the business, from the 19 fraud that's occurring in the general accounting office; 20 correct? 21 A. Yes. 22 Q. So Mike Martin has some reason why he doesn't want you to 23 see these corporate books; right? 24 A. I would assume, yes. 25 THE COURT: He had to do with the field but not the</p>	<p style="text-align: right;">Page 185</p> <p>1 corporate compliance officer for the organization at the 2 time. 3 Q. Executive VP, where in this corporate structure? 4 A. He would have reported directly to Richard. He would 5 have responsibility for Human Resources and Marketing, and he 6 is not on the chart. 7 THE COURT: Would he be -- would he have occupied 8 the same position as Ms. Cullison later? 9 THE WITNESS: That would have been Ms. Cullison's 10 direct boss. Yes. She reported directly to him and also had 11 a dotted line to me as well. 12 THE COURT: Okay. When did you go to Tony 13 Tanner? 14 THE WITNESS: Probably in the '98 -- I can't 15 remember exactly when the discussion would have occurred but 16 I know it was probably in the '98, '99 time frame. So I know 17 I had a discussion with him when I was trying to make a 18 decision about leaving HealthSouth, about the issues that I 19 was continuing to have with Mike and the battles we were 20 having over what access we had to the books. 21 THE COURT: What did he tell you when you approached 22 him, Tony Tanner? 23 THE WITNESS: He said that he would try to help me 24 to find out why Mike was doing this and get our access turned 25 back on.</p>

<p style="text-align: right;">Page 186</p> <p>1 THE COURT: And then?</p> <p>2 THE WITNESS: And we did get our access back to the</p> <p>3 field level.</p> <p>4 BY MR. SJOBLOM:</p> <p>5 Q. When did that happen?</p> <p>6 A. Honestly, I don't remember. It had to have been toward</p> <p>7 the latter part of '98, '99.</p> <p>8 Q. And it was Mr. Tanner that helped cause that?</p> <p>9 A. Yes.</p> <p>10 Q. Now, did Mr. Scrusby ever say to you in these Monday</p> <p>11 morning meetings or when you were reporting to the audit</p> <p>12 committee, if you ever need to talk to me about these things,</p> <p>13 feel free to schedule a meeting?</p> <p>14 A. No, sir. He did not make that type of --</p> <p>15 Q. He never ever offered to talk to you about anything, is</p> <p>16 that what you're saying?</p> <p>17 A. No. I'm not saying that he never ever offered to talk to</p> <p>18 me about anything --</p> <p>19 Q. But you --</p> <p>20 THE COURT: Let her finish her answer, Mr. Sjoblom.</p> <p>21 If you don't let her finish her answer, I'm not going to let</p> <p>22 you ask any questions. Somebody else can do it if you can't</p> <p>23 do it right. Now, let her finish her answer.</p> <p>24 BY MR. SJOBLOM:</p> <p>25 Q. Go ahead.</p>	<p style="text-align: right;">Page 188</p> <p>1 A. Correct.</p> <p>2 THE COURT: Did you ever go by his office to see</p> <p>3 him?</p> <p>4 THE WITNESS: Not up on the 5th floor. No, ma'am, I</p> <p>5 did not.</p> <p>6 BY MR. SJOBLOM:</p> <p>7 Q. Were you aware -- well, I guess I'm talking about the</p> <p>8 last two years, 1997 until November '99, were you made aware</p> <p>9 did it ever come to your attention in any way, shape, or</p> <p>10 form, that there was some type of fraud occurring within the</p> <p>11 accounting staff of HealthSouth?</p> <p>12 A. No.</p> <p>13 Q. A rumor?</p> <p>14 A. Rumors. I mean there were rumors that they were playing</p> <p>15 with numbers, yes.</p> <p>16 Q. Rumors from whom?</p> <p>17 A. Honestly, I don't remember exactly who would have made</p> <p>18 those comments.</p> <p>19 Q. This is a rumor about fiddling with the numbers on the</p> <p>20 financial statements?</p> <p>21 A. Correct.</p> <p>22 Q. And what are your duties as the internal auditor of the</p> <p>23 company?</p> <p>24 A. To review the financial operations of the field, of the</p> <p>25 field locations is what I was hired to do.</p>
<p style="text-align: right;">Page 187</p> <p>1 A. Not that he never offered that. Yes, he did offer that.</p> <p>2 However, it was not during a Monday morning time frame,</p> <p>3 Monday morning meetings, because that was when -- there were</p> <p>4 a hundred people that were in that room. We had to get</p> <p>5 through our meetings. And that was not the forum in which</p> <p>6 you would have that type of conversation with Mr. Scrusby.</p> <p>7 That was more of a one-on-one situation that I would have</p> <p>8 talked to him.</p> <p>9 Q. Did you ever speak to his secretary -- Let me put it this</p> <p>10 way: Who controlled his schedule?</p> <p>11 A. His secretary.</p> <p>12 Q. It's through the secretary that you did not get this</p> <p>13 meeting?</p> <p>14 A. Correct.</p> <p>15 Q. You don't know -- the implication you're giving me is</p> <p>16 that Mr. Scrusby denied you access to him. In fact, it could</p> <p>17 have been his secretary that, for some reason, couldn't get a</p> <p>18 meeting scheduled. Is that possible?</p> <p>19 A. I would imagine that is possible. Yes.</p> <p>20 Q. Was it your secretary calling his secretary trying to</p> <p>21 arrange a meeting?</p> <p>22 A. No. It was me calling his secretary directly.</p> <p>23 Q. And for whatever reason, it didn't happen?</p> <p>24 A. Correct.</p> <p>25 Q. It was through the secretary?</p>	<p style="text-align: right;">Page 189</p> <p>1 Q. Did you do anything as part of your functions as the</p> <p>2 internal auditor of the company to check out those rumors and</p> <p>3 find out where this fraud could be going on?</p> <p>4 A. That's when I would have started requesting the access to</p> <p>5 the corporate level books, because that would be the only way</p> <p>6 I could verify that --</p> <p>7 Q. And that's your request to Mike Martin when it shut down</p> <p>8 correct?</p> <p>9 A. Yes.</p> <p>10 Q. Did you ever create a memo about your concerns about</p> <p>11 being denied access?</p> <p>12 A. No, sir. We were discouraged from writing that kind of</p> <p>13 information on memos that could be discoverable in an</p> <p>14 investigation.</p> <p>15 Q. Who told you that? General counsel?</p> <p>16 A. It was a direction from the attorneys within the</p> <p>17 organization, yes.</p> <p>18 Q. Mr. Horton and his office?</p> <p>19 A. That would have been -- that actual direction would have</p> <p>20 come from Drew Demaray.</p> <p>21 Q. Through -- I'm sorry?</p> <p>22 A. Drew Demaray.</p> <p>23 Q. Who is Drew Demaray?</p> <p>24 A. He is an attorney there in the legal department. He</p> <p>25 worked very closely with our compliance program.</p>

<p style="text-align: right;">Page 190</p> <p>1 Q. And he's in the general counsel's office?</p> <p>2 A. Yes, he is.</p> <p>3 Q. Did Mr. Scrusby ever say to you, don't send me a memo,</p> <p>4 don't send me an e-mail, I don't want to hear about this.</p> <p>5 Did he ever make any kind of comments like that?</p> <p>6 A. Not to me no, sir.</p> <p>7 Q. You're aware of the fraud program, the 1-800 fraud</p> <p>8 program?</p> <p>9 A. I'm very aware of that.</p> <p>10 Q. Are you a trainer in that?</p> <p>11 A. I was not a trainer but I was one who answered phone</p> <p>12 calls on that, yes.</p> <p>13 Q. Was the corporate ethic at HealthSouth one in which they</p> <p>14 were trying to establish corporate integrity as a New York</p> <p>15 Stock Exchange company?</p> <p>16 A. Yes.</p> <p>17 Q. And where was that message emanating from?</p> <p>18 A. That originated from Mr. Scrusby.</p> <p>19 Q. He created this program; correct?</p> <p>20 A. Right.</p> <p>21 Q. And he encouraged people, if you see anything or hear</p> <p>22 anything, call human resources or use your fraud card; right?</p> <p>23 A. Correct.</p> <p>24 Q. Did you ever do that?</p> <p>25 A. Did I ever do that?</p>	<p style="text-align: right;">Page 192</p> <p>1 the assets of the company.</p> <p>2 Q. Well, that's the books and records provision, isn't it?</p> <p>3 Are you talking about the Foreign Corrupt Practice Act. Are</p> <p>4 you familiar with that?</p> <p>5 A. I'm familiar with it. Not very familiar, but I'm aware</p> <p>6 of it.</p> <p>7 Q. Are you aware -- I'm sorry.</p> <p>8 A. I'm not very familiar with it, but I am aware of it.</p> <p>9 Yes.</p> <p>10 Q. You're aware that there are two requirements. One is to</p> <p>11 have accurate books and records to accurately reflect the</p> <p>12 transactions and disposition of assets, No. 1; right?</p> <p>13 A. Correct.</p> <p>14 Q. No. 2, you're aware that there has to be internal</p> <p>15 accounting controls within the corporation?</p> <p>16 A. Correct.</p> <p>17 Q. A system of internal accounting controls; right?</p> <p>18 A. Yes.</p> <p>19 Q. And you knew that at E&amp;Y; correct?</p> <p>20 A. Yes.</p> <p>21 Q. You knew that when you came into HealthSouth as part of</p> <p>22 the internal audit department?</p> <p>23 A. Yes.</p> <p>24 Q. And you know that today?</p> <p>25 A. Yes.</p>
<p style="text-align: right;">Page 191</p> <p>1 Q. Yes.</p> <p>2 A. As the chief auditing officer, no, sir. I did not do</p> <p>3 that.</p> <p>4 Q. So you've got rumors circulating of some notions about</p> <p>5 fraud going on. You are the in-house auditor of the company,</p> <p>6 and you did nothing about it?</p> <p>7 A. You could look at it that way, yes, sir.</p> <p>8 THE COURT: I thought you said you went to Tony</p> <p>9 Tanner.</p> <p>10 THE WITNESS: I talked to Tony when I didn't have my</p> <p>11 access. When Mike cut my access off to the records, then I</p> <p>12 did talk to him about that.</p> <p>13 BY MR. SJOBLUM:</p> <p>14 Q. Could you turn to Page 5 of Exhibit 2, please? You say</p> <p>15 you're a CPA, AICP member and chief fraud examiner; right?</p> <p>16 A. No, only a CPA. I'm a member of the organizations.</p> <p>17 Q. You know what internal controls are?</p> <p>18 A. Yes. I'm very aware of those.</p> <p>19 Q. How are you so aware of it?</p> <p>20 A. I worked with it.</p> <p>21 Q. What have you done?</p> <p>22 A. That is part of what internal audit does.</p> <p>23 Q. What is your understanding of internal accounting</p> <p>24 controls?</p> <p>25 A. They are the policies and procedures set up to safeguard</p>	<p style="text-align: right;">Page 193</p> <p>1 Q. Now, look at Page 5 of Exhibit No. 2. I want you to</p> <p>2 focus on the right side of the page, if you might.</p> <p>3 A. Okay.</p> <p>4 Q. You see the administration or administrator for one of</p> <p>5 the 1800 facilities; you saw that in the middle of the page;</p> <p>6 right?</p> <p>7 A. Yes.</p> <p>8 Q. As far as internal controls, what happens at the level of</p> <p>9 the facility by the facility administrator? Internal</p> <p>10 control, what is he supposed to do?</p> <p>11 A. He is supposed to follow the policies and procedures that</p> <p>12 are established by the corporate office.</p> <p>13 Q. Who established those?</p> <p>14 A. It would have been the accounting department and the</p> <p>15 operations people that would have established the policies</p> <p>16 and procedures.</p> <p>17 Q. Did the internal audit department have any input into</p> <p>18 establishing internal controls within HealthSouth?</p> <p>19 A. No, we did not. We didn't write the policies. We just</p> <p>20 audited what the policies --</p> <p>21 Q. But you're aware that there was an internal control</p> <p>22 policy all the way down to the bottom of each administrator</p> <p>23 of the facility, right?</p> <p>24 A. Internal control policy?</p> <p>25 Q. Yes.</p>

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<p>1 A. There were policies on how to prepare financial packages                  2 and all. You could say that was internal control                  3 environment, yes.                  4 Q. Let's back up a minute. What is your understanding of                  5 the internal accounting control structure in place at                  6 HealthSouth?                  7 A. The internal accounting control structure at HealthSouth                  8 at the time that I was there, would have been the facilities                  9 issued financial packages which were sent to the corporate                  10 office. The entries were booked by staff accountants at the                  11 corporate office. The run of financial statements, after                  12 they had booked those entries, were sent back to the facility                  13 for review.                  14 Q. Can I interrupt you for one moment, please?                  15 A. Uh-huh.                  16 Q. You are talking now about the interrelationship between                  17 the left side of the page, each facility has an accounting                  18 staff and an administrator, correct? That's the numbers that                  19 are flowing back and forth, is that what you're talking                  20 about?                  21 A. Correct.                  22 Q. So the numbers are coming from facilities to the                  23 accounting staff -- the accounting staff is creating                  24 financial information from those numbers and sending some                  25 kind of statement that's called a profit and loss statement?</p>	<p>1 A. It went through several levels of review, yes.                  2 Q. In your opinion, does the internal control structure                  3 satisfy the --                  4 THE COURT REPORTER: I'm sorry?                  5 BY MR. SJOBLOM:                  6 Q. As the internal auditor of HealthSouth, is it your                  7 opinion that this internal control structure at HealthSouth                  8 satisfied what you understand, as an accountant, to be                  9 required for a public company traded on the New York Stock                  10 Exchange?                  11 A. Based on what your definition was that you gave me, yes.                  12 Q. Are you aware of a more heightened requirement than that                  13 which is in place for a New York Stock Exchange company?                  14 A. No, sir, I'm not.                  15 Q. Now, what types of books and records within the                  16 corporation were you aware of that were in position as the                  17 numbers worked its way up to this internal control structure?                  18 A. There was the facility level general ledger, which is                  19 what went back and forth between the field. The financial                  20 packages, which were what the field actually submitted to the                  21 corporate office to book, those entries. And then there                  22 would have been the consolidated books where all the                  23 information from the facilities was rolled together to report                  24 either on a monthly or a quarterly basis. I know they had to                  25 generate those kind of things to go through their 10-K and</p>
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<p>1 A. It would have been a general ledger, is what they would                  2 have sent --                  3 Q. A general ledger. Send that information on to the                  4 administrator, right?                  5 A. Correct.                  6 Q. That administrator then takes a look at those general                  7 ledgers to see if it accurately reflects the business                  8 activities of that facility; is that right?                  9 A. Correct.                  10 Q. What happens next?                  11 A. If they had no adjusting entries then, from what I                  12 understand, they would have run a second run of financial                  13 statements, which I assume would be prior to the                  14 consolidated. And then once those numbers were finalized,                  15 they would have been consolidated into the corporate level.                  16 Q. I think in less than one minute you just took us from                  17 administration up through the Regional VP's, Group VP's,                  18 Senior VP's, finance, controller, up to the consolidation by                  19 the three division presidents, is that what you just did?                  20 A. Sure.                  21 Q. It took me longer to draw this. Would it be fair to say                  22 that the internal control structure at HealthSouth was an                  23 elaborate system?                  24 A. An elaborate system?                  25 Q. An elaborate system?</p>	<p>1 their 10-Q.                  2 Q. Were there adequate books and records at HealthSouth to                  3 come up with a consolidated financial statement that                  4 accurately reflected what was going on from the facility all                  5 the way up?                  6 A. I can only say what was present in the field. Since I                  7 didn't have access to the corporate level books, I would not                  8 have known --                  9 Q. Let's stay on the operations side. Were there sufficient                  10 books and records, general ledgers, everything that went into                  11 the financial package that ultimately led up to the                  12 consolidated --                  13 A. In the field, yes.                  14 Q. Do you have any understanding about the charges that are                  15 brought by the SEC in terms of the inflation of the property,                  16 plant, and equipment account?                  17 A. I have read the complaint that was filed, yes.                  18 Q. Do you have any understanding of -- strike that.                  19 While you were there, and by serving in the office of the                  20 internal audit department, did anything come to your                  21 attention that this property, plant, and equipment account                  22 was being manipulated?                  23 A. No, sir.                  24 Q. I think the complaint also talks about effectively give                  25 it up; right?</p>

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<p>1 A. Correct.</p> <p>2 Q. While you were there at the internal audit department of</p> <p>3 HealthSouth, did any information come to your attention that</p> <p>4 the EBITDA number was being artificially manipulated?</p> <p>5 A. No, sir. There were no reports or no direct allegations</p> <p>6 or anything, no.</p> <p>7 Q. So whatever is happening is over, as best you know, away</p> <p>8 from you in the finance and accounting side; right?</p> <p>9 A. At the corporate level, yes.</p> <p>10 Q. And you are in this independent audit department</p> <p>11 reporting upstairs, if you will, to the chairman. But you,</p> <p>12 the chief auditor for the company, are totally oblivious to</p> <p>13 what's going on the operations side, as regards the charges</p> <p>14 being brought by the SEC; right?</p> <p>15 A. Correct.</p> <p>16 Q. Are you familiar with a concept called "the family"?</p> <p>17 A. "The family"?</p> <p>18 Q. Yes.</p> <p>19 A. No, sir. Other than what I've read, no, sir, I am not</p> <p>20 aware of that.</p> <p>21 Q. Mr. Owens was engaged in a fairly extensive acquisitions</p> <p>22 program while he was at HealthSouth; is that right?</p> <p>23 A. Fairly extensive? What do you mean --</p> <p>24 Q. Acquisitions?</p> <p>25 A. Acquisitions of other facilities, is that what you mean?</p>	<p>1 Function?</p> <p>2 A. I'm very aware of that program, yes.</p> <p>3 Q. When did it start?</p> <p>4 A. It started in 1996.</p> <p>5 Q. How did it get started?</p> <p>6 A. It was actually the brainchild of Mr. Scrushy. He asked</p> <p>7 me to put together a 50-point checklist so that an auditor</p> <p>8 could walk in a facility and look for these 50 items and</p> <p>9 verify that those items were either present or not present.</p> <p>10 Q. So, you just had a meeting with Mr. Scrushy. You're</p> <p>11 talking about setting up a 50-point system for the outside</p> <p>12 auditors to come in and do an audit of the company; right?</p> <p>13 A. Correct.</p> <p>14 Q. When did that happen?</p> <p>15 A. In 1996.</p> <p>16 Q. Did you have discussions with him after 1996 through the</p> <p>17 time period you were there about this Pristine Audit Program?</p> <p>18 A. I believe we had one or two discussions about it, yes.</p> <p>19 Q. Had one in 1997?</p> <p>20 A. Just to schedule his time when he would be presenting to</p> <p>21 the Pristine auditors.</p> <p>22 Q. 1998?</p> <p>23 A. That would have been to schedule his time to present to</p> <p>24 the Pristine auditors.</p> <p>25 Q. 1999?</p>
<p>Page 199</p> <p>1 Q. Yes. Businesses facilities, actively engaged in growing</p> <p>2 the business of HealthSouth through acquisitions?</p> <p>3 A. While I was there, Mr. Owens was the corporate</p> <p>4 controller.</p> <p>5 Q. Okay.</p> <p>6 A. So whether he was involved in that part of it or not, I'm</p> <p>7 not aware what his involvement or how deep it would be. My</p> <p>8 knowledge of the company, the person that was in charge of</p> <p>9 acquisitions was Tom Carman.</p> <p>10 Q. Did Mr. Owens ever ask you to participate in any due</p> <p>11 diligence regarding acquisitions?</p> <p>12 A. Only one time.</p> <p>13 Q. When was that?</p> <p>14 A. That was with the acquisition of NME. I cannot remember</p> <p>15 what NME stood for. I went on one due diligence trip with</p> <p>16 Weston Smith, Bill Owens, Sharon Faulkner, and Frank Dicesare</p> <p>17 to Pennsylvania.</p> <p>18 Q. When was this?</p> <p>19 A. I can't remember when we did that acquisition. I'm going</p> <p>20 to guess and say it was probably the '94 time frame. I can't</p> <p>21 remember when that acquisition occurred, quite honestly.</p> <p>22 Q. When did you say you left HealthSouth?</p> <p>23 A. 1999 -- November of 1999.</p> <p>24 Q. With respect to the outside audit function, were you</p> <p>25 aware of a program through E&amp;Y called the Pristine Audit</p>	<p>Page 201</p> <p>1 A. To schedule a time for him to present it to the Pristine</p> <p>2 auditors.</p> <p>3 Q. So you had meetings with Mr. Scrushy?</p> <p>4 A. Didn't have a meeting, no, sir.</p> <p>5 Q. You talked about the 50 points and how to schedule these</p> <p>6 audits for E&amp;Y; right?</p> <p>7 A. We had a 10-minute meeting, approximately, where he gave</p> <p>8 me the idea of what he wanted accomplished and told me to go</p> <p>9 forth and get it done and I did.</p> <p>10 Q. Let me back up a minute. You decided that this very</p> <p>11 critical --</p> <p>12 THE COURT: We're going to take a break. The court</p> <p>13 reporter needs a break. Take a 15-minute break.</p> <p>14 (Recess from 3:08 p.m. to 3:25 p.m.)</p> <p>15 BY MR. SJOBLOM:</p> <p>16 Q. Ms. Sanders, did you have any conversation with any</p> <p>17 representatives of the Securities and Exchange Commission</p> <p>18 during this last break?</p> <p>19 A. During this last break?</p> <p>20 Q. Yes.</p> <p>21 A. No. Just a few moments in the witness room.</p> <p>22 Q. Did they discuss with you any of the topics we're</p> <p>23 discussing on your cross examination?</p> <p>24 A. No. All they said was I was doing okay and keep my chin</p> <p>25 up.</p>

<p style="text-align: right;">Page 202</p> <p>1 Q. I want you to keep your chin up?</p> <p>2 A. (Laughing).</p> <p>3 Q. So there's no topic that we have been discussing that</p> <p>4 they advised you on during this break?</p> <p>5 A. No, sir.</p> <p>6 Q. Okay. Thank you. Now, I think we were talking about the</p> <p>7 Pristine Audit Program and we were in Defendants' Exhibit No.</p> <p>8 1, Page 5, and I think we established that that started in</p> <p>9 1996, is that correct?</p> <p>10 A. 1996, correct. Is this --</p> <p>11 THE COURT: I don't think we've gotten to Exhibit 1</p> <p>12 yet.</p> <p>13 BY MR. SJOBLUM:</p> <p>14 Q. Now, was it your testimony that the idea behind the</p> <p>15 Pristine Audit Program emanated from Mr. Scrusby?</p> <p>16 A. Correct.</p> <p>17 Q. Did you have discussions with him about what he had in</p> <p>18 mind, why he wanted this program?</p> <p>19 A. We had approximately a 10- to 15-minute conversation</p> <p>20 about what he wanted. He explained that he wanted a 50-item</p> <p>21 checklist that anyone could walk into a facility and it had</p> <p>22 to be yes/no answers and basically things that you could look</p> <p>23 at in a facility. For example, if there were stains on the</p> <p>24 ceiling, basically the aesthetics of the facility, what the</p> <p>25 environment of the facility was.</p>	<p style="text-align: right;">Page 204</p> <p>1 A. I wouldn't say that it was for them to understand how the</p> <p>2 internal audit function worked better. It was actually just</p> <p>3 to go to the facilities and do the 50-item checklist for us.</p> <p>4 THE COURT: Would the 50-item checklist have</p> <p>5 anything to do with finances?</p> <p>6 THE WITNESS: No, ma'am.</p> <p>7 THE COURT: Could we all move on?</p> <p>8 MR. LOOMIS: No objection to moving on, Your Honor.</p> <p>9 THE COURT: Well, I was hoping -- Never mind.</p> <p>10 MR. LOOMIS: I will object on the grounds of</p> <p>11 relevance.</p> <p>12 THE COURT: Sustained.</p> <p>13 BY MR. SJOBLUM:</p> <p>14 Q. Why would you train E&amp;Y auditors to go into a facility to</p> <p>15 see -- What did you say? Paint marks on the ceiling?</p> <p>16 A. Stains on the ceiling.</p> <p>17 Q. Stains on the ceiling. Why would E&amp;Y spend their time</p> <p>18 and money training 76 auditors over a three-year period to</p> <p>19 find out if there are stains on the ceiling?</p> <p>20 MR. LOOMIS: I thought Your Honor sustained my</p> <p>21 objection. I would again renew my objection on grounds of</p> <p>22 relevancy.</p> <p>23 THE COURT: Well, I am going to sustain on the</p> <p>24 ground that she wouldn't know why E&amp;Y did something.</p> <p>25 BY MR. SJOBLUM:</p>
<p style="text-align: right;">Page 203</p> <p>1 THE COURT: Sorry. I'm not sure I understand what</p> <p>2 kind of 50-point checklist you're talking about here. Are</p> <p>3 you talking about some kind of audit checklist or facilities</p> <p>4 checklist?</p> <p>5 THE WITNESS: It would be like a checklist that</p> <p>6 you'd go into the facility, but we had Ernst &amp; Young auditors</p> <p>7 go in with those checklists; and basically, "Was the</p> <p>8 receptionist friendly?" You check yes or no.</p> <p>9 THE COURT: Had nothing to do with the audits?</p> <p>10 THE WITNESS: Had nothing to do with the audits.</p> <p>11 No, ma'am. This was a totally separate thing.</p> <p>12 THE COURT: Okay.</p> <p>13 BY MR. SJOBLUM:</p> <p>14 Q. Were you a trainer for any of the Ernst &amp; Young people</p> <p>15 for this audit program?</p> <p>16 A. Yes, I was.</p> <p>17 Q. How many people at Ernst &amp; Young did you train for this</p> <p>18 function?</p> <p>19 A. Oh gosh. Ball park, probably 75 people from across the</p> <p>20 United States.</p> <p>21 Q. From 1996 to '99?</p> <p>22 A. Yes.</p> <p>23 Q. And Ernst &amp; Young's interest in learning how to be part</p> <p>24 or learning to understand better the internal audit function</p> <p>25 was provided to this program; right?</p>	<p style="text-align: right;">Page 205</p> <p>1 Q. What were some of the 50 points on this checklist, other</p> <p>2 than stains on the ceiling?</p> <p>3 A. Was the receptionist friendly when you were greeted by</p> <p>4 the facility? Were there magazines in the lobby?</p> <p>5 MR. LOOMIS: Your Honor, could I object again on the</p> <p>6 grounds of relevancy?</p> <p>7 THE COURT: Sustained.</p> <p>8 BY MR. SJOBLUM:</p> <p>9 Q. Was there any point on that 50-point checklist that had</p> <p>10 anything to do with a book or a record that related to</p> <p>11 financial information or a payable or receivable, anything</p> <p>12 like that?</p> <p>13 A. The only thing that they were to check was petty cash to</p> <p>14 make sure it was in a locked drawer. As far as the payable</p> <p>15 and receivable, no. Ending last year, if I remember</p> <p>16 correctly, we asked them to write down an asset tag number.</p> <p>17 Q. What does that mean?</p> <p>18 A. A fixed asset would be like a piece of equipment that's</p> <p>19 in the facility and that would have a tag number that would</p> <p>20 tie to a report at the corporate office.</p> <p>21 Q. Does that include property, plant and equipment?</p> <p>22 A. Fixed assets, yes.</p> <p>23 Q. So it does have to do with the assets of the operations</p> <p>24 side of the business; right?</p> <p>25 A. Right. There was one question on the list, yes, that</p>

<p style="text-align: right;">Page 206</p> <p>1 asked that.</p> <p>2 THE COURT: Was that question whether or not -- when</p> <p>3 they checked equipment, whether or not it had a number on</p> <p>4 it?</p> <p>5 THE WITNESS: They would just write down the number,</p> <p>6 the asset tag number. And then they would e-mail that</p> <p>7 information back to us, and we would verify that that tag</p> <p>8 agreed to the one on the list at the corporate office --</p> <p>9 THE COURT: Would they actually go through every --</p> <p>10 and put equipment, chair, desk?</p> <p>11 THE WITNESS: No. They would just look and see if</p> <p>12 the piece of equipment had it and then just write down --</p> <p>13 just randomly pick one.</p> <p>14 THE COURT: Oh. Okay.</p> <p>15 BY MR. SJOBLOM:</p> <p>16 Q. You mentioned something about petty cash being locked</p> <p>17 up. Did you ever have reported to you theft of cash within</p> <p>18 the corporation of HealthSouth?</p> <p>19 A. Yes.</p> <p>20 Q. How many times do you think?</p> <p>21 A. Gosh. That's hard to judge. I mean, we would probably</p> <p>22 have three or four a year that they would report petty cash.</p> <p>23 Q. What size dollars are you talking about?</p> <p>24 A. The outpatient facilities, they usually had a \$50</p> <p>25 balance. And the inpatient facilities, they could have</p>	<p style="text-align: right;">Page 208</p> <p>1 the end of the year. That was going through the AP and</p> <p>2 checking for invoices that had not been recorded on the books</p> <p>3 as liabilities.</p> <p>4 Q. Through the AP?</p> <p>5 A. The accounts payable -- excuse me -- looking for</p> <p>6 invoices that had not been accrued on the books as being a</p> <p>7 liability at the end of the year.</p> <p>8 We would, if I remember correctly, get the bank</p> <p>9 statements for them from the finance department or the</p> <p>10 accounting department. That would have been Kay Morgan that</p> <p>11 we would have gotten that information from.</p> <p>12 Off the top of my head, those are the two main things</p> <p>13 that we did for them at the end of the year.</p> <p>14 Q. When you say "the AP", does that have anything to do at</p> <p>15 all with the AP summary that is being charged by the SEC in</p> <p>16 this case?</p> <p>17 A. That would have been the detailed invoices that would</p> <p>18 have made up an AP summary.</p> <p>19 Q. Let's back up, then. What is this AP -- When you saw an</p> <p>20 AP or an AP summary document, a number that reflected AP --</p> <p>21 A. There would be a detailed ledger called an accounts</p> <p>22 payable ledger.</p> <p>23 Q. Right.</p> <p>24 A. That total should agree to -- If there was an AP summary</p> <p>25 entry made on a general ledger, there should be an AP</p>
<p style="text-align: right;">Page 207</p> <p>1 anywhere from \$100 to maybe \$350.</p> <p>2 Q. You mean a minimum level before you would take a look at</p> <p>3 it or --</p> <p>4 A. That would be the maximum level that they would have,</p> <p>5 correct.</p> <p>6 Q. All right. Did you ever have a meeting with Mr. Scrusby</p> <p>7 about theft of cash from the company?</p> <p>8 A. No, sir.</p> <p>9 Q. Never?</p> <p>10 A. No, sir.</p> <p>11 Q. So you are the internal audit person. Who did you report</p> <p>12 the theft of cash to?</p> <p>13 A. I would have reported it to the regional vice presidents</p> <p>14 of operations, all the regional VP's and on up. It was such</p> <p>15 an immaterial amount that -- I mean, he would have seen it on</p> <p>16 my summary reports, yes.</p> <p>17 THE COURT: Who is "he"?</p> <p>18 THE WITNESS: Mr. Scrusby. He would have seen it on</p> <p>19 my summary reports, yes.</p> <p>20 BY MR. SJOBLOM:</p> <p>21 Q. Did you interact with Ernst &amp; Young when they were</p> <p>22 providing the outside auditing services?</p> <p>23 A. We would perform some procedures for them, yes.</p> <p>24 Q. What types of procedures?</p> <p>25 A. We would do like a search for unrecorded liabilities at</p>	<p style="text-align: right;">Page 209</p> <p>1 detailed ledger that that number -- the total of all those</p> <p>2 invoices that were paid would agree to what was on that</p> <p>3 general ledger.</p> <p>4 Q. For how long a period of time did you see this AP ledger</p> <p>5 and AP summary?</p> <p>6 A. That was from the very beginning. That would have been</p> <p>7 for the facilities.</p> <p>8 Q. When you saw it, where did it come from? Which</p> <p>9 department in the company did it come from?</p> <p>10 A. The AP ledger?</p> <p>11 Q. Right.</p> <p>12 A. The AP ledger would have come from the accounts payable</p> <p>13 department.</p> <p>14 Q. On the accounting staff?</p> <p>15 A. On the accounting staff, correct, for the corporate</p> <p>16 office.</p> <p>17 Q. So the operations people would provide this to the</p> <p>18 accounting staff; they would provide an AP summary with</p> <p>19 backup detail and provide it to you. Is that how it worked?</p> <p>20 A. No.</p> <p>21 Q. How does it work?</p> <p>22 A. When checks were paid at the corporate office -- All</p> <p>23 checks were paid at the corporate office. None of the</p> <p>24 facilities had the ability to write a check. All of that</p> <p>25 came from the corporate office.</p>

<p style="text-align: right;">Page 210</p> <p>1 THE COURT: For all 1800 facilities?</p> <p>2 THE WITNESS: For all 1800 facilities, yes, ma'am.</p> <p>3 Those were entered by an accounts payable clerk. An AP</p> <p>4 general ledger would be generated for that check, run for</p> <p>5 that week. And then that information, that ledger, would be</p> <p>6 sent back to the facility as evidence of what checks had been</p> <p>7 paid for that week or what invoices had been paid for that</p> <p>8 week.</p> <p>9 BY MR. SJOBLOM:</p> <p>10 Q. Would you know whether or not anything on that AP ledger</p> <p>11 had been inflated or was bogus?</p> <p>12 A. If it was a facility that we were auditing and it would</p> <p>13 be one of the sample invoices that we pulled, we would have</p> <p>14 pulled the backup for the item that we were testing. So</p> <p>15 would I know whether it was bogus or not? I can't say.</p> <p>16 Q. Did you, in the course of your tenure there, do sample</p> <p>17 audits, inpatient operations, outpatient rehab, and surgery</p> <p>18 centers?</p> <p>19 A. When we were at the facilities, yes, we tested that in</p> <p>20 accounts payable. Yes.</p> <p>21 Q. How frequently did you do that?</p> <p>22 A. That would be based on the facilities that we tested for</p> <p>23 the year. When I first started, there were only 35</p> <p>24 facilities, and I probably got to -- I did one a week</p> <p>25 approximately. So I probably got to, let's say, 25 of</p>	<p style="text-align: right;">Page 212</p> <p>1 THE WITNESS: Anything over 50,000, correct.</p> <p>2 THE COURT: But, basically, you're telling me that</p> <p>3 Mr. Scrusby was in charge of -- as being the signature on the</p> <p>4 check, of payments of accounts that were charged to all 1800</p> <p>5 facilities?</p> <p>6 THE WITNESS: Yes, ma'am. His signature would have</p> <p>7 been on the check, yes.</p> <p>8 BY MR. SJOBLOM:</p> <p>9 Q. That's an automated or electronic?</p> <p>10 A. Correct.</p> <p>11 Q. Is that paid out of the treasury department? Which</p> <p>12 department handled that?</p> <p>13 A. Accounts payable generated the checks.</p> <p>14 Q. So they had a check, and it was an automatic signature</p> <p>15 that they just applied it whenever they --</p> <p>16 A. If it was paying for a check, I mean, that would have</p> <p>17 been --</p> <p>18 Q. You're not suggesting that every check paid by</p> <p>19 HealthSouth for all the facilities, all across the world, all</p> <p>20 went to that man's desk and he approved them?</p> <p>21 A. No, sir, I'm not saying that at all, no.</p> <p>22 THE COURT: But you are telling me, if I understand</p> <p>23 correctly, that the entire financial operations of all the</p> <p>24 1800 facilities were consolidated in headquarters?</p> <p>25 THE WITNESS: Yes, ma'am. All the checks were</p>
<p style="text-align: right;">Page 211</p> <p>1 those.</p> <p>2 As the company grew, we were able to do fewer of those</p> <p>3 because the staff was very small. We only had a staff of</p> <p>4 about ten auditors in all to be able to do that kind of</p> <p>5 thing. So you were doing it on a random basis based on the</p> <p>6 facility that you were auditing at the time.</p> <p>7 Q. Did Mr. Bennett also have a staff of approximately 35</p> <p>8 auditors or accountants working with him?</p> <p>9 A. No, sir.</p> <p>10 THE COURT: Who would write those checks for the</p> <p>11 whole incorporation?</p> <p>12 THE WITNESS: Well, they were computer-generated</p> <p>13 checks.</p> <p>14 THE COURT: Who had signature authority?</p> <p>15 THE WITNESS: That would have been Richard -- I</p> <p>16 mean, it was Richard's signature that was on the checks. It</p> <p>17 was a computer-generated signature. The Treasury Department</p> <p>18 for checks over, I believe it was \$50,000, had to have a</p> <p>19 second signature or initial. And that would have come from</p> <p>20 the Treasury Department. Usually that was Catherine Fowler.</p> <p>21 Q. So there was internal control in place --</p> <p>22 A. Correct.</p> <p>23 Q. -- for check signing?</p> <p>24 A. Correct.</p> <p>25 THE COURT: Anything over 50?</p>	<p style="text-align: right;">Page 213</p> <p>1 generated from there. They had bank accounts that they made</p> <p>2 deposits to. They only had the ability to make deposits.</p> <p>3 They had no check writing capabilities whatsoever.</p> <p>4 THE COURT: All right.</p> <p>5 BY MR. SJOBLOM:</p> <p>6 Q. Does that fall under the chief financial officer?</p> <p>7 A. Yes.</p> <p>8 Q. And the chief financial officer during the time period</p> <p>9 you were there were who, which people?</p> <p>10 A. I had Aaron Bearn when I first started, Mike Martin, and</p> <p>11 that was it.</p> <p>12 Q. Now, let's go back to your relationship with the outside</p> <p>13 auditors. When the outside auditors would come into the</p> <p>14 company and do the annual audit for the 10-K, did you</p> <p>15 interface with the outside auditors?</p> <p>16 A. They would ask me their normal questions, you know, when</p> <p>17 have you been this year? Review our schedule.</p> <p>18 Q. If you had any problems or anything like that, right?</p> <p>19 A. Right.</p> <p>20 Q. Did you tell them you didn't have access to the corporate</p> <p>21 books?</p> <p>22 A. They knew that I did not have access, yes.</p> <p>23 Q. Who?</p> <p>24 A. The auditors knew that, yes.</p> <p>25 Q. Who at Ernst &amp; Young did you tell that you cannot get</p>

<p style="text-align: right;">Page 214</p> <p>1 access to the corporate books and records?                  2 A. That would have been Curt Miller, Wayne Dunn. They knew                  3 that we did not have access to the corporate general ledgers.                  4 Q. Curt Miller?                  5 A. Correct. At the time, he was the senior manager. Dick                  6 Dandurand was the partner.                  7 THE COURT: Who?                  8 THE WITNESS: Dick Dandurand, D-a-n-d-u-r-a-n-d.                  9 BY MR. SJOBLOM:                  10 Q. Let's back up. Curt Miller is the senior manager?                  11 A. Correct.                  12 Q. Wayne Dunn is what?                  13 A. Probably the manager.                  14 Q. Manager.                  15 A. And to be honest with you, we had so many of the staff                  16 auditors, I don't remember.                  17 Q. Who is the audit manager?                  18 A. The audit manager probably would have been Wayne Dunn at                  19 the time.                  20 Q. Who was the partner in charge of the --                  21 A. That would be Dick Dandurand.                  22 Q. Can you spell again, please?                  23 A. D-a-n-d-u-r-a-n-d.                  24 Q. Did you explain to these gentlemen, starting from the                  25 time Mike Martin cut you off in '97, that each time they came</p>	<p style="text-align: right;">Page 216</p> <p>1 A. We probably met -- or I probably met with them. And                  2 understand that when you say "audit committee," it was                  3 technically the full board of the company.                  4 Q. That's correct.                  5 A. We were supposed to meet on a quarterly basis. Usually,                  6 it was anywhere from three to four times a year. It would                  7 just vary on what times of year that I was supposed to be --                  8 Q. As you were preparing either a 10-Q or you were preparing                  9 a 10-K, is that right?                  10 A. No. Those meetings were not scheduled then. No, sir.                  11 Q. What do you mean by quarterly basis?                  12 A. Probably been like a February meeting. I'm trying to                  13 remember because I'm getting my two companies mixed up. I                  14 know we had a May meeting. There was the big annual meeting,                  15 which was usually in February. There was an August. And                  16 then usually there was either one in October or in December,                  17 I can't remember which.                  18 Q. At any time in one of those meetings with the full board,                  19 where you're talking either an internal audit function or                  20 when Ernst &amp; Young is the outside auditor, did you ever say                  21 to any board member, I need to have access to the corporate                  22 records and the corporate software?                  23 A. No, sir, I did not. That was not the environment --                  24 Q. Why not?                  25 A. -- that you usually brought those types of things up in.</p>
<p style="text-align: right;">Page 215</p> <p>1 in to do the annual audit for the 10-K, you told them, I                  2 cannot have access to the books and records, corporate                  3 accounting records, and the corporate accounting software?                  4 A. They understood that I did not have that access the                  5 entire time that I worked with HealthSouth from 1990.                  6 Q. And what did they say to you about it?                  7 A. They didn't say anything.                  8 Q. Did you sit in the presentation by the outside auditors                  9 with the board at the conclusion of the audit by Ernst &amp;                  10 Young?                  11 A. Yes, I did.                  12 Q. Did Ernst &amp; Young ever say in that conclusion of the                  13 audit, oh, by the way, your internal auditor needs to have                  14 access to the corporate accounting records?                  15 A. No, sir, they did not.                  16 Q. Did they ever mention it in any of their papers that it                  17 was an issue they were concerned about?                  18 A. Not that I'm aware of.                  19 Q. Do you have an explanation for why that was not mentioned                  20 if it was critical?                  21 A. No, sir, I don't.                  22 Q. How many times were you involved in making a presentation                  23 to the audit committee about the status of an internal audit                  24 or participating with the outside auditors with the board of                  25 Directors?</p>	<p style="text-align: right;">Page 217</p> <p>1 No, sir. Mr. Scrusby did not like surprises, and I was                  2 not about to make a comment like that at a meeting.                  3 Q. Wait a minute. I mean, there are breaks in the meeting,                  4 there is time after the meeting, there was time before the                  5 meeting.                  6 A. I wasn't in the meetings during all that time, sir. I                  7 was only brought in to do my presentation, and then I left                  8 when my presentation was over.                  9 Q. How many board members are there?                  10 A. I have no idea. It's been such a long time.                  11 Q. 10? 20?                  12 A. No, there's not 20.                  13 Q. 15?                  14 A. There were probably 10 at the time.                  15 Q. Over this '97 to '99 time period and maybe perhaps                  16 earlier, you never found a moment in three or four years                  17 where you could say to any one of those ten men or women, by                  18 the way, I'm the chief internal auditor, and I need to see                  19 the corporate records on occasion?                  20 A. I didn't have interaction with those people. No, sir, I                  21 did not. Other than when I did my presentations at those                  22 meetings, that was about the only time that I would see those                  23 people, yes.                  24 Q. Are you the chief internal auditor for the company?                  25 A. At the present time, I'm the compliance officer, yes.</p>

<p style="text-align: right;">Page 218</p> <p>1 Q. Isn't your job to make sure that on an internal basis 2 that the audits are performed and all the accounting records 3 and accounting information is correct within the company? 4 A. Yes. 5 Q. That's your job? 6 A. That is my job, and I can assure you now I make sure I 7 have that access to that. 8 Q. When we really get down to it, isn't your No. 1 9 responsibility to make sure that the financial figures within 10 the company are accurate? 11 A. You could say that, yes. 12 Q. So that's your chief job, that's the main reason for your 13 purpose. And as a New York Stock Exchange company to have an 14 internal audit department, you could not find any place in 15 four or five years where you could say to someone, I need to 16 see the corporate records? 17 A. I did say that to Tony Tanner, yes. 18 Q. That's later, right? 19 A. That was in the '97-'98 time frame, yes. 20 Q. One time? 21 A. No, not one time. 22 Q. How many times? 23 A. Probably three or four times that I had conversations. 24 You have to understand that I traveled an enormous amount 25 with this job. I was out in the field an enormous amount of</p>	<p style="text-align: right;">Page 220</p> <p>1 and say, by the way, I need the corporate records? 2 A. I probably could have, but I wouldn't have been very 3 comfortable with doing that. 4 Q. Why not? 5 A. I didn't have that type of relationship with the board of 6 directors. 7 Q. You are the chief IG in the corporation. You are the cop 8 inside the company. And you, for four years, did not ask 9 people, I need to see some of these key documents. Is that 10 what you're saying? 11 A. I asked the people that were at the corporate office, the 12 ones that would have been able to grant me the access for 13 that access, and I was denied. 14 Q. Mike Martin? 15 A. Correct. 16 Q. And as the chief officer cop within the company, you 17 didn't feel you could go up to Mike Martin and say, I've got 18 to have this. We are a publicly traded company. We trade 19 all over the United States. Our financial records have to be 20 accurate. I am the chief auditor, and I don't have access to 21 the main books and records to fulfill my function? 22 A. And that is why I was trying to get the meeting with Mr. 23 Scruschy. 24 Q. But you did have a meeting with Mr. Scruschy. You met 25 about the Pristine Audit Program; right?</p>
<p style="text-align: right;">Page 219</p> <p>1 time, so I was not there to actually have those 2 conversations. 3 Q. Did you ever write a memo to someone -- 4 THE COURT: Wait. Did you get that? 5 THE COURT REPORTER: Yes. 6 MR. SJOBLOM: I apologize. 7 BY MR. SJOBLOM: 8 Q. Did you ever write a memo to someone as the chief auditor 9 of the company and say, it is critical that I have access to 10 these books and records? 11 A. No, sir, I did not. 12 Q. Why not? 13 A. In retrospect, I probably should have at this point in 14 time. But we were careful as to what we put in memos due to 15 being concerned about what would be discoverable in an 16 investigation. 17 Q. Or a litigation? 18 A. Correct. 19 Q. And other than meeting someone personally, do you know 20 any of the board members? Do you know who they are? 21 A. I know them. I would recognize them by face, yes. But I 22 don't know them, no, personally. 23 Q. Do they live here in Birmingham, some of them? 24 A. I believe Dr. Watkins does, yes. 25 Q. Could you not pick up the telephone and call Dr. Watkins</p>	<p style="text-align: right;">Page 221</p> <p>1 A. For 10 minutes about the Pristine Audit Program, yes. 2 Maybe 15 minutes, 10 to 15 minutes about the Pristine Audit 3 Program. 4 Q. Your testimony is that from 1996 to 1999, this Pristine 5 Audit Program, you had one meeting -- I'll take that back. 6 This was right before the break -- you had meetings in 1996; 7 right? 8 A. We had the 10- to 15-minute meeting to come up with the 9 concept. I sent him up what my design was on the checklist. 10 He sent it back down, and it was approved. We did not sit 11 down and discuss it in great detail. The only other meeting 12 that we had -- And when I say "meeting," we're not talking 13 about a face-to-face, sit-down, have a long discussion about 14 it. I'm talking about I talked to his secretary to schedule 15 the time that he is doing the presentation to the Pristine 16 auditors. 17 Q. And you said before the break you talked to him in '97 18 perhaps -- 19 THE COURT: Can I just say something? 20 MR. SJOBLOM: Sure. 21 THE COURT: I have heard this testimony four times 22 now, and I've got it. 23 BY MS. SJOBLOM: 24 Q. Just a couple of quick questions about controls. Did you 25 write any of the policies or procedures for internal</p>

<p style="text-align: right;">Page 222</p> <p>1 controls?</p> <p>2 A. No, sir, I did not.</p> <p>3 Q. Did you have anything to do with writing the collections</p> <p>4 policies or some of the billing and cash control policies?</p> <p>5 A. No.</p> <p>6 Q. Who wrote those?</p> <p>7 A. I would imagine someone from the finance department wrote</p> <p>8 those.</p> <p>9 Q. Did anybody bring any of those to you for your approval</p> <p>10 or perusal?</p> <p>11 A. No, sir.</p> <p>12 Q. The finance department is operated independently, is that</p> <p>13 what you're saying?</p> <p>14 A. Correct.</p> <p>15 Q. Under Mike Martin's authority?</p> <p>16 A. Correct.</p> <p>17 Q. Ms. Sanders, you testified that you saw the AP ledgers</p> <p>18 with some detailed information that came up on the operations</p> <p>19 side; right?</p> <p>20 A. Correct.</p> <p>21 Q. Did any of that information have anything, any bearing</p> <p>22 whatsoever on the corporate financial records?</p> <p>23 A. The detailed AP ledgers?</p> <p>24 Q. Right.</p> <p>25 A. I would imagine that they would have rolled up into the</p>	<p style="text-align: right;">Page 224</p> <p>1 about some of the relevance of some of this. I did tell you</p> <p>2 I had all the time in the world, but I just do think that</p> <p>3 there needs to be some relevance to what the issues are.</p> <p>4 MR. HICKS: I concur. I'm going to offer some</p> <p>5 documents now.</p> <p>6 THE COURT: All right.</p> <p>7 MR. HICKS: I would like to offer the declaration of</p> <p>8 Stephanie Christian, who is in records facilities for</p> <p>9 HealthSouth and deals with the options trading by Mr.</p> <p>10 Scruschy. It was included in our exhibits, and we filed in</p> <p>11 opposition to their motion to lift the freeze. I've complied</p> <p>12 with 902.</p> <p>13 THE COURT: The one that you filed on April 8th?</p> <p>14 MR. LOOMIS: Yes, ma'am, Your Honor.</p> <p>15 THE COURT: I also have one that you filed on March</p> <p>16 31st.</p> <p>17 MR. LOOMIS: We've had two filings. We made one in</p> <p>18 chambers that was attached to our brief that was in</p> <p>19 opposition to their motion to lift the asset freeze to pay</p> <p>20 for attorney's fees. We also did a filing with the clerk's</p> <p>21 office which is filed stamped April 3rd. The April 3rd one</p> <p>22 is the one that has the affidavit to it.</p> <p>23 MR. SJOBLOM: Judge?</p> <p>24 THE COURT: Hold on.</p> <p>25 MR. SJOBLOM: Your Honor?</p>
<p style="text-align: right;">Page 223</p> <p>1 corporate ledgers. I mean, all of the facility general</p> <p>2 ledgers would have been consolidated into the corporate level</p> <p>3 books. Yes.</p> <p>4 Q. Did you see any of that rolled-up information?</p> <p>5 A. No, sir. That would have been done at the corporate</p> <p>6 level. I didn't have access to that corporate level.</p> <p>7 Q. That's Mike Martin again?</p> <p>8 A. That would be Mike Martin.</p> <p>9 THE COURT: I thought Mike Martin just cut you off</p> <p>10 from the field.</p> <p>11 THE WITNESS: He cut me off from the field, yes.</p> <p>12 THE COURT: He didn't have anything to do with</p> <p>13 cutting you off from corporate?</p> <p>14 THE WITNESS: Right. Because I never had access to</p> <p>15 corporate records.</p> <p>16 THE COURT: That's what I thought. Just get the</p> <p>17 record straight. So it wasn't Mike Martin that cut you off</p> <p>18 from corporate?</p> <p>19 THE WITNESS: I never had access to corporate.</p> <p>20 THE COURT: Okay.</p> <p>21 MR. SJOBLOM: We have no further questions.</p> <p>22 THE COURT: Thank you. You may be excused.</p> <p>23 May I remind you what issues we are on here today?</p> <p>24 MR. HICKS: Yes, ma'am.</p> <p>25 THE COURT: Okay. Well, I've just kind of wondered</p>	<p style="text-align: right;">Page 225</p> <p>1 THE COURT: Hang on just a second.</p> <p>2 MR. LOOMIS: I believe that's Tab 5 in that.</p> <p>3 THE COURT: Filed on April 3rd?</p> <p>4 MR. LOOMIS: Yes, ma'am.</p> <p>5 THE COURT: Along with your amended complaint?</p> <p>6 Well, I mean, I'm looking to see what was filed -- Let's</p> <p>7 see. No. 5. Declaration of Stephanie Christian?</p> <p>8 MR. LOOMIS: That's it.</p> <p>9 THE COURT: I've got it.</p> <p>10 MR. SJOBLOM: Your Honor, we object on the grounds</p> <p>11 of hearsay. I believe they're offering this for the truth of</p> <p>12 the matter asserted as to the schedule about the options.</p> <p>13 It's clearly hearsay.</p> <p>14 We've not had a chance to cross-examine this person. I</p> <p>15 have a number of questions about this chart, particularly</p> <p>16 when they're offering it for the purposes of establishing</p> <p>17 insider trading violations.</p> <p>18 THE COURT: Yes, I'm going to sustain your</p> <p>19 objection. You are going to have to call her. She can't</p> <p>20 testify by affidavit.</p> <p>21 MR. HICKS: We'll put her on the stand.</p> <p>22 THE COURT: Okay.</p> <p>23 STEPHANIE IRENE CHRISTIAN</p> <p>24 was sworn/affirmed and testified as follows:</p> <p>25 BY THE COURTROOM DEPUTY:</p>

<p style="text-align: right;">Page 1519</p> <p>1 THE WITNESS: That was my understanding.                  2 THE COURT: Did it ever occur to anybody at Ernst                  3 &amp; Young to go to HealthSouth and say, let's send Mike                  4 Martin on vacation for a while and let's talk to the people                  5 such as Teresa Sanders who has an issue with him?                  6 THE WITNESS: We did not do that. No.                  7 THE COURT: But you are familiar with, I think                  8 it's pretty common practice, for example, banks send                  9 tellers on vacation to make sure that they are not stealing                  10 money from the bank and the books are all right. Right?                  11 That's a typical way for a bank to control that there's not                  12 cooking of the books in the bank and tellers stealing from                  13 them, isn't that correct?                  14 THE WITNESS: I believe so.                  15 THE COURT: So you could have suggested that Mike                  16 Martin be sent on vacation so you could go talk to Teresa                  17 Sanders?                  18 THE WITNESS: Yes, we could have.                  19 THE COURT: She could have shown you what she was                  20 talking about or what she had a personality problem with                  21 him about?                  22 THE WITNESS: Yes, ma'am.                  23 THE COURT: What did you do when you found out                  24 that she had a, what you called a personality problem with                  25 Mike Martin, what did you do about it?</p>	<p style="text-align: right;">Page 1521</p> <p>1 MR. TALLY: Your Honor, may we approach to take                  2 up one matter before we start?                  3 THE COURT: Yes.                  4 (Side bar discussion off the record.)                  5 (Open court.)                  6 THE COURT: All right. Let the record show this                  7 is after lunch. You may call your next witness.                  8 MR. SJOBLOM: We call as our next witness Mr.                  9 James Lamphron of Ernst &amp; Young.                  10 THE COURT: Okay. I see a couple of lawyers over                  11 on both sides missing.                  12 MR. MAYS: Yes, Your Honor.                  13 MR. HICKS: Yes, Your Honor.                  14 THE COURT: Good afternoon.                  15 THE WITNESS: Hello.                  16 JAMES LAMPHRON, SWORN.                  17 THE CLERK: Will you state your full name for the                  18 record into the mike?                  19 THE WITNESS: Yes, James Patrick Lamphron.                  20 THE CLERK: Will you spell your last name?                  21 THE WITNESS: L-a-m-p-h-r-o-n.                  22 THE CLERK: The city and state where you live?                  23 THE WITNESS: Birmingham, Alabama.                  24 DIRECT EXAMINATION                  25 BY MR. SJOBLOM:</p>
<p style="text-align: right;">Page 1520</p> <p>1 THE WITNESS: I'm not aware of anything that we                  2 did.                  3 THE COURT: But she was the one in charge of                  4 internal audit, right?                  5 THE WITNESS: Yes, ma'am.                  6 THE COURT: And Mike Martin was the CFO, chief                  7 financial officer?                  8 THE WITNESS: Yes, ma'am.                  9 THE COURT: You didn't think it was important                  10 enough to talk to her as the head of the internal audit                  11 department to find out why she had a problem with the CFO?                  12 THE WITNESS: I know that Teresa had told us that                  13 she was overworked and was tired of all the travel and that                  14 she was wanting to find something else that was --                  15 THE COURT: Is that what you call a personality                  16 problem?                  17 THE WITNESS: That was something additional.                  18 THE COURT: Okay. All right. Thank you.                  19 Anything else from anyone?                  20 MR. HICKS: No, ma'am.                  21 MR. TALLY: May he be excused?                  22 MR. SJOBLOM: Thank you.                  23 THE COURT: Be back at two o'clock. We're going                  24 to adjourn until two o'clock.                  25 (Lunch recess)</p>	<p style="text-align: right;">Page 1522</p> <p>1 Q Good afternoon, Mr. Lamphron. My name is Thomas                  2 Sjoblom and I represent Mr. Scrusby in this proceeding. We                  3 have not met, sir, prior to morning; is that right?                  4 A That's correct.                  5 Q We have not talked about what your testimony would be                  6 here this afternoon?                  7 A That's correct.                  8 Q I will try to make this as quick and painless as I can                  9 and get you in and out of here. Can you give me your                  10 education, please?                  11 A I have a liberal arts degree from the University of                  12 Mississippi. I graduated in 1969. I have a bachelor of                  13 science in business from the University of West Florida in                  14 1975.                  15 Q In accounting?                  16 A Yes.                  17 Q Do you have a masters degree or any other advanced                  18 degrees in accounting?                  19 A No.                  20 Q MBA?                  21 A No.                  22 Q Are you a CPA?                  23 A Yes.                  24 Q When did you receive your license?                  25 A 1977.</p>

<p style="text-align: right;">Page 1523</p> <p>1 Q When did you first become employed at Ernst &amp; Young?                  2 A September 15th, 1975.                  3 Q Okay. What are your positions -- what were your                  4 positions as you have moved up the ranks?                  5 A The normal progression through the ranks as an audit                  6 staff person, through senior, through manager, through                  7 senior manager and then partner.                  8 Q When did you --                  9 THE COURT: I'm sorry. How about principal?                  10 THE WITNESS: I was not a principal.                  11 THE COURT: What's the difference between partner                  12 and principal?                  13 THE WITNESS: Principal is typically reserved for                  14 someone who's got a special role within the firm in a                  15 specialty area. Some people will move to principal, might                  16 become a partner. Some might move to principal and stay                  17 there as a career.                  18 THE COURT: And stay there as a what?                  19 THE WITNESS: Stay there for their career, their                  20 entire career.                  21 THE COURT: So the principal is more like a job                  22 designation --                  23 THE WITNESS: Well, it is a --                  24 THE COURT: -- or expertise or something?                  25 THE WITNESS: We describe it as a partner level</p>	<p style="text-align: right;">Page 1525</p> <p>1 and Ernst &amp; Whinny, and I don't know if a partner rotated                  2 off, retired or what the circumstances were.                  3 Q Do you recall whether or not or do you recall that                  4 HealthSouth became a New York Stock Exchange publicly                  5 traded company in 1989?                  6 A No, sir.                  7 Q What were your duties as independent review partner in                  8 1988?                  9 A Well, again, I'm not sure it was 1988. It was in the                  10 '88-'89 time frame. But as an independent review partner,                  11 my responsibilities were to review the financial statements                  12 and other documentation prior to the issuance of our report                  13 on the company's financial statements.                  14 Q Prior to the issuance of the annual report?                  15 A Prior to the issuance of our report, our opinion.                  16 Q On the annual report?                  17 A On the company's financial statements.                  18 Q On the annual report?                  19 A No. Our opinion on their financial statements.                  20 THE COURT: Now, Mr. Sjoblom wants to know if it                  21 was in connection with the annual report.                  22 THE WITNESS: It was in connection with the                  23 filing of their annual report on the form 10-K, that's                  24 correct. I'm sorry.                  25 Q You drafted or wrote the opinion letter that was part</p>
<p style="text-align: right;">Page 1524</p> <p>1 position. But typically, someone in that role would have                  2 some special expertise in a particular area, some technical                  3 area.                  4 THE COURT: Would you know what Mr. Miller's                  5 expertise is?                  6 THE WITNESS: Generally, it was in reimbursement                  7 issues.                  8 THE COURT: Okay.                  9 Q (By Mr. Sjoblom) And you are a partner at Ernst &amp;                  10 Young?                  11 A That's correct.                  12 Q When were you audit manager?                  13 A I was an audit manager in 1980.                  14 Q With respect to HealthSouth, what was the first time                  15 you performed any type of audit services for HealthSouth?                  16 A I'm not sure exactly. My best recollection is                  17 probably 1988, 1989.                  18 Q In what connection?                  19 A I was the independent review partner.                  20 Q What was happening in 1988 that needed your services                  21 at HealthSouth?                  22 A Well, an independent review partner is a role we have                  23 on all of our audit engagements as part of our quality                  24 control process. And the specifics, I don't recall at this                  25 point, but it was shortly after the merger of Arthur, Young</p>	<p style="text-align: right;">Page 1526</p> <p>1 of that annual report filed with the SEC?                  2 A I did not.                  3 Q These services you performed were in connection with                  4 the issuance of that opinion letter, right?                  5 A That's correct.                  6 Q What was your next involvement with HealthSouth as an                  7 auditor?                  8 A All except one year during that period of '88 to '89                  9 through 1999, I was the independent review partner. In                  10 2000, I became the coordinating partner and the audit                  11 engagement partner.                  12 THE COURT: Coordinating what?                  13 THE WITNESS: Coordinating partner.                  14 THE COURT: Okay. And --                  15 THE WITNESS: And the audit engagement partner.                  16 Q What is the coordinating review partner?                  17 A The coordinating partner is responsible for the entire                  18 client-related engagement. The audit engagement partner is                  19 responsible specifically for the audit service that we                  20 provided.                  21 Q You served in both capacities?                  22 A That's correct.                  23 Q Tell me again what the coordinating partner does.                  24 A He is responsible for the entire client relationship.                  25 That means providing of the audit services and any other</p>

<p style="text-align: right;">Page 1527</p> <p>1 types of services that we might provide.                  2 Q Okay. And that you started in the year 2000?                  3 A That's correct.                  4 Q Was that for the year end annual report for 2000, or                  5 did that start back in January 2000 at the beginning of the                  6 year?                  7 A I don't recall when I officially moved into that role,                  8 but it was for the -- I served as the engagement partner,                  9 audit engagement partner for the calendar year 2000                  10 audit.                  11 Q And then you continued in that capacity for the year                  12 2001 and year 2002?                  13 A Through 2002 until we stopped the audit process.                  14 Q Which occurred a couple of months ago or a month ago,                  15 right?                  16 A Five weeks ago.                  17 Q Five weeks ago. Okay. Have you provided any                  18 assistance to the new auditors in going back through the                  19 records to understand what happened?                  20 A I have not.                  21 Q Okay. All right. Let me show you Defendant's Exhibit                  22 2-1, which is a breakdown between the corporate side of                  23 HealthSouth, finance and accounting and the operations                  24 side. Are you with me?                  25 A Yes, sir.</p>	<p style="text-align: right;">Page 1529</p> <p>1 MR. TALLY: 0338.                  2 MR. SJOBLOM: Sorry. Bates stamp page 0340, 340.                  3 Q Mr. Lampron, were you present at a board meeting on                  4 May 16th, 2002 at HealthSouth?                  5 A Yes, I was.                  6 Q Okay. If you would, take a look at the bottom of Page                  7 Bates stamp Page 340 and the top of 341, and tell me                  8 whether or not that refreshes your recollection as to                  9 whether or not you ever said to the board of directors                  10 there were no material deficiencies of internal controls?                  11 A The -- I don't specifically recall this meeting. I                  12 would believe these minutes are accurate, and I would                  13 believe that I did, in fact, indicate there were no                  14 material weaknesses.                  15 Q In internal controls?                  16 A Yes.                  17 Q Are you talking about the operations side or the                  18 corporate financing, or are you talking about whole                  19 corporation?                  20 A The internal controls over the financial areas.                  21 Q Let's go to Defendant's Exhibit 2-2, the finance and                  22 accounting side. This chart demonstrates or illustrates                  23 some of departments that are at issue in this case, and it                  24 includes the general accounting office and the accounts                  25 payable.</p>
<p style="text-align: right;">Page 1528</p> <p>1 Q Let's just quickly talk about the operations side. In                  2 your capacity as coordinating partner and audit engagement                  3 partner -- and I'm mostly concerned now with -- well, let's                  4 also include 1999 as the independent review partner. Did                  5 you have any role in assessing the internal control                  6 structure of the operations side of the business?                  7 A Our firm did, and I ultimately had responsibility for                  8 reviewing our final conclusions.                  9 Q What was your final conclusion?                  10 A Well, let me restate that. We don't form a conclusion                  11 on the system of internal controls. We review the system                  12 of internal controls in sufficient detail to allow us to                  13 design our audit process and our substantive testing. We                  14 don't look at the system in sufficient detail to allow us                  15 to opine on that system.                  16 Q Did you ever express to a board meeting of board                  17 members of HealthSouth that there were no material                  18 deficiencies in the internal controls of HealthSouth?                  19 A I don't recall.                  20 Q Okay. We have -- do you have a set of white books up                  21 there, two volumes? In the second volume, which are the                  22 board minutes of Exhibit 35, would you look at the page                  23 Bates stamped, I think it's 0338?                  24 THE COURT: What Bates stamp?                  25 MR. SJOBLOM: Let me doublecheck.</p>	<p style="text-align: right;">Page 1530</p> <p>1 If I understand your testimony and your opinion                  2 about no material deficiencies of internal controls, it                  3 relates to the finance and accounting side of the                  4 corporation. Is that what you're talking about?                  5 A Just to clarify, we did not issue an opinion saying                  6 there were no material weaknesses. We indicated a form of                  7 negative assurance, saying no material weaknesses came to                  8 our attention.                  9 Q I'm not talking about a written opinion. I'm talking                  10 about the statements that you made to the board of                  11 directors.                  12 A I think it would have been made in the same manner.                  13 Q But this --                  14 THE COURT: I'm sorry. I misunderstood you. Did                  15 you say to the board of directors on May the 16th, 2002                  16 that you found no material weakness in internal controls?                  17 THE WITNESS: I did.                  18 Q Okay. Now, with respect to books and records, as the                  19 -- let's take them one at a time. In 1999 as the                  20 independent review partner, did you ask your -- strike                  21 that.                  22 How does the independent review partner interact,                  23 if you will, with the audit team? What is that                  24 relationship?                  25 A Typically, early in the audit process, I would review</p>

<p style="text-align: right;">Page 1531</p> <p>1 certain planning documents, audit strategy memo, maybe some                  2 other documentation which lays out the course of our audit.                  3 Then later during the year, after the execution of most of                  4 the audit procedures, I would come in and review what we                  5 might identify as issues, the documentation of those                  6 issues, and I would look at the company's financial                  7 statements and their form 10-K and their annual report                  8 totals.                  9 Q Did you for the year 2001 find any issues in                  10 connection with the audit that needs to be addressed?                  11 A There were issues -- there are issues in virtually all                  12 audits. I do not specifically know what issues we dealt                  13 with in 2001, but I believe there were issues.                  14 Q Were there any major issues over the accuracy of books                  15 and records?                  16 A Nothing to do with the accuracy of the books and                  17 records, that's correct.                  18 Q Any issues over disagreement with management in terms                  19 of accounting philosophies or any of those type of                  20 things?                  21 A In the course of -- there were no disagreements as                  22 defined by professional auditing literature, that's                  23 correct.                  24 Q Would that include management's application of some of                  25 the GAAP principles?</p>	<p style="text-align: right;">Page 1533</p> <p>1 Q The annual?                  2 A The annual audit, that's correct.                  3 Q Were you present -- well, did you make a report to the                  4 audit committee?                  5 A I made a report to the audit committee, yes, and to                  6 the board of directors.                  7 Q Do you recall what you told the audit committee?                  8 A No, I don't.                  9 Q If you look at the top paragraph on Page 336, have you                  10 had a chance to review it?                  11 A Just a moment, please.                  12 Q Just the top paragraph.                  13 A Okay.                  14 Q Just the top paragraph on 336.                  15 A Yes, I've read it.                  16 Q Does that refresh your recollection as to what you                  17 might have said at the audit committee?                  18 A I don't recall exactly what we talked about. We had                  19 an agenda, a full agenda, and we talked about a number of                  20 things. The meeting was probably thirty to forty-five                  21 minutes in length. It was a summary of our audit findings                  22 and issues, resolutions, that sort of thing.                  23 Q Did you indicate to the audit committee that the Ernst                  24 &amp; Young audit for 2001 was more thorough this year as a                  25 result of the Enron and Arthur Andersen issues?</p>
<p style="text-align: right;">Page 1532</p> <p>1 A That's correct.                  2 Q You had no disagreement with the board on how they                  3 applied GAAP to the financial statements or the earnings?                  4 A I had no disagreement, that's correct.                  5 Q Now, this board meeting on May 16th, 2002, this would                  6 be your report as regards the 2001 figure; is that right?                  7 A That's correct.                  8 Q Did you issue an opinion letter in connection with the                  9 2001 annual report and form 10-K?                  10 A Yes.                  11 Q Do you know whether it was qualified or clean?                  12 A It was unqualified, unmodified report.                  13 Q And clean?                  14 A A clean opinion.                  15 Q Bear with me just one moment. Did you attend a board                  16 meeting on March 15, 2002, in which you made a presentation                  17 to HealthSouth board members? Do you recall?                  18 A I made -- I attended a board meeting in about that                  19 time in March. I'm not sure of the specific date.                  20 Q Sure. If you look at volume two at Bates stamp Page                  21 335 and 336. This meeting was held on March 15, 2002. Do                  22 you recall what it was in connection with? Was it the year                  23 end for 2001 or was this a quarterly meeting?                  24 A It was a meeting with the board of directors in                  25 connection with the 2001 audit.</p>	<p style="text-align: right;">Page 1534</p> <p>1 A Not in those words, I didn't.                  2 Q What did you say?                  3 A I don't recall exactly.                  4 Q Well, in the context of what's happened with Enron and                  5 Arthur Andersen, has Ernst &amp; Young as far as its practices,                  6 heightened the level of its auditing practices?                  7 A I'm sorry. Ask that again.                  8 Q As a result of Enron, Arthur Andersen, has Ernst &amp;                  9 Young heightened or increased the level of its audit                  10 practices?                  11 A We've made only changes to our audit approach.                  12 Q A more heightened level of scrutiny than before?                  13 A Maybe focusing in different areas, that sort of thing.                  14 Q Is it more extensive and more thorough than it was in                  15 prior years?                  16 A I think we've always done thorough audits.                  17 Q I didn't ask you that. As a result of Enron and                  18 Arthur Andersen, isn't it a fact that all accounting firms                  19 in the United States are now being more careful and more                  20 thorough than they have been in the past?                  21 MR. HICKS: Objection, there's no foundation for                  22 that.                  23 THE COURT: Overruled. Just testify about Ernst                  24 &amp; Young.                  25 A We have changed our audit approach. I can't address</p>

<p style="text-align: right;">Page 1535</p> <p>1 whether it's more thorough or less thorough.                  2 Q How have you change your audit approach?                  3 A We have focused on some of the areas that were                  4 highlighted in the Enron situation.                  5 THE COURT: Which are?                  6 THE WITNESS: Partnerships, off balance sheet                  7 accounting issues, guarantees, disclosure issues, that type                  8 of thing.                  9 Q Did you find any off balance sheet financing in                  10 HealthSouth?                  11 A Yes.                  12 Q You did?                  13 A Yes.                  14 Q Where are those?                  15 A The company was engaged in several synthetic leases                  16 which are defined as off balance sheet type financing                  17 arrangements.                  18 Q Was it anything with which you thought there was an                  19 accounting problem?                  20 A No, sir.                  21 Q What other areas?                  22 A I don't know of any others. I don't recall.                  23 Q In connection with that meeting with the board and the                  24 audit committee in March of 2002, did you indicate to the                  25 board that you found none of the Enron type problems?</p>	<p style="text-align: right;">Page 1537</p> <p>1 Replacement in what capacity?                  2 A Well, he retired from the firm. He had been the audit                  3 engagement partner. He retired, and I took over for him in                  4 2000.                  5 Q So this is where you become audit engagement                  6 partner?                  7 A That's correct.                  8 Q And the coordinating partner?                  9 A Yes.                  10 Q In connection with the audit for the year 2000, which                  11 you reported in March of 2001, did you encounter any issues                  12 that created a problem with the audit or disagreement of                  13 management?                  14 A I don't recall the specific nature of the issues.                  15 There again, there are issues encountered in most audits.                  16 I'm sure there were some there. They were resolved to our                  17 satisfaction.                  18 Q There's a reference in this minute to high risk areas.                  19 What are high risk areas?                  20 A Those are areas that we identify in our planning                  21 process where we identify certain areas as being more                  22 sensitive, more subject to estimation, sometimes more                  23 difficult to audit. Those areas we deem to be higher risk                  24 and we focus on those in the audit process.                  25 Q Can you give me an example?</p>
<p style="text-align: right;">Page 1536</p> <p>1 A I believe I did.                  2 Q Okay. Pardon me for one moment. Now, in the prior                  3 year, in March 2001, did you hold a meeting with the board                  4 and the audit committee about the 2000 year end audit?                  5 A Yes, we did.                  6 Q Okay. Do you recall what was discussed at that                  7 meeting?                  8 A Not specifically.                  9 Q Would you look at, again in Volume Two, Page 283 and                  10 284, in particular the top of 284?                  11 A (Witness complies.) Yes.                  12 Q Okay. Does that refresh your recollection as to what                  13 was said?                  14 A Again, I don't recall the specific issues I talked                  15 about, but what we -- the norm was we met with the audit                  16 committee, we discussed in some level of detail the results                  17 of our audit, the areas of audit emphasis, issues, that                  18 sort of thing, and then a high level summary of that was                  19 made to the board. The report lasted maybe five minutes.                  20 Q Who is Mr. Dandurand?                  21 A Dandurand is a retired partner with Ernst &amp; Young. He                  22 retired during 2000.                  23 Q And you indicate on -- or at least this minute                  24 indicates that you look forward to working more closely                  25 with HealthSouth as Mr. Dandurand's replacement.</p>	<p style="text-align: right;">Page 1538</p> <p>1 A The contractual reimbursement area.                  2 Q The contractual -- I'm sorry?                  3 A The allowance for doubtful accounts.                  4 THE COURT: The allowance for what?                  5 THE WITNESS: Doubtful accounts.                  6 THE COURT: Okay.                  7 Q Did you look at the contractual adjustment account?                  8 A I did.                  9 Q And did you discover any problems in that account that                  10 materially affected the audit or -- start there, materially                  11 affected the audit?                  12 A At the end of the day, we were satisfied with the                  13 balances in those accounts.                  14 Q Now, I notice that on that same page right beneath                  15 that internal audit report, that information has been                  16 redacted out. Do you know who the director of internal                  17 audit was at HealthSouth?                  18 A I believe it was Greg Smith, but I'm not certain.                  19 Q Do you someone by the name of Teresa Sanders?                  20 A I know the name Teresa Sanders. She -- it's my                  21 understanding she was a predecessor of Greg Smith's. She                  22 was not the director of internal audit while I was the                  23 engagement partner.                  24 Q Do you know when she became director of internal                  25 audit?</p>

<p style="text-align: right;">Page 1539</p> <p>1 A No.</p> <p>2 Q Did you ever have any occasion to have a conversation</p> <p>3 with Ms. Smith about her internal audit practices?</p> <p>4 A No. With, you said, Ms. Smith?</p> <p>5 Q Excuse me. Teresa Sanders?</p> <p>6 A Teresa Sanders, no.</p> <p>7 Q How about Mr. Smith?</p> <p>8 A No.</p> <p>9 Q When Mr. Dandurand was the coordinating partner and</p> <p>10 the audit engagement partner, did you attend audit</p> <p>11 committee meetings and board of directors meetings with Mr.</p> <p>12 Dandurand at HealthSouth?</p> <p>13 A I did not.</p> <p>14 Q You did not. When did you start attending board</p> <p>15 meetings and audit committee meetings at HealthSouth?</p> <p>16 A In 2000. Well, in connection with the 2000 audit. I</p> <p>17 believe the first audit committee or board meeting that I</p> <p>18 attended was the March 2001 meeting.</p> <p>19 Q Okay. You can set that aside.</p> <p>20 Do you have an understanding of how the consolidation</p> <p>21 process worked at HealthSouth?</p> <p>22 A Personally, I don't.</p> <p>23 Q Did you ever review any payments in connection with</p> <p>24 the consolidation process?</p> <p>25 A I have reviewed consolidating work papers in what we</p>	<p style="text-align: right;">Page 1541</p> <p>1 ledgers, subsidiary ledgers, general ledgers, then you're</p> <p>2 talking about consolidating work papers, is that kind of</p> <p>3 the hierarchy of the paperwork?</p> <p>4 A That's correct.</p> <p>5 Q And above that, what do you get?</p> <p>6 A You could have summarized financial -- well, financial</p> <p>7 statements.</p> <p>8 Q Okay. Let me direct your attention to Exhibit 2-5.</p> <p>9 By the time the consolidation process reaches the CFO, what</p> <p>10 is he looking at: Intermediary ledgers, general ledgers</p> <p>11 or consolidating work papers?</p> <p>12 MR. HICKS: Objection, calls for speculation.</p> <p>13 THE COURT: Sustained.</p> <p>14 Q In connection with the audit you performed, Mr.</p> <p>15 Lamphron, did anything ever come to your attention, I'm</p> <p>16 talking about prior to the newspapers, prior to March 2003,</p> <p>17 in fact, prior to December 31, 2002, did anything ever come</p> <p>18 to your attention that suggested that there was a fraud</p> <p>19 going on at HealthSouth?</p> <p>20 A No.</p> <p>21 Q Anything ever come to your attention in connection</p> <p>22 with talking to your audit team, talking to your lower</p> <p>23 level managers that Mr. Scrusby had knowledge of a</p> <p>24 financial fraud at HealthSouth?</p> <p>25 A No.</p>
<p style="text-align: right;">Page 1540</p> <p>1 call a general review type of capacity.</p> <p>2 Q And that general review, what is the level of detail</p> <p>3 that you seek?</p> <p>4 A It was what would be a fairly typical consolidating</p> <p>5 worksheet with columns of aggregated numbers, some</p> <p>6 consolidating or eliminating type adjustments to come up</p> <p>7 with final balances that would then tie in or reconcile</p> <p>8 back to the published financial statements.</p> <p>9 Q In your review of that consolidating worksheet, did</p> <p>10 you ever come across any information that you felt was</p> <p>11 problematical?</p> <p>12 A Not that I recall.</p> <p>13 Q Did you ever come across, in your review, any</p> <p>14 information on a general ledger or on a consolidated ledger</p> <p>15 that led you to believe that there was something fraudulent</p> <p>16 or numbers were artificially inflated?</p> <p>17 A I never reviewed a general ledger or consolidating</p> <p>18 ledger.</p> <p>19 Q So on a consolidated ledger is maybe the next level of</p> <p>20 summary data above the general ledgers?</p> <p>21 A Well, I'm not sure what the term consolidating ledger</p> <p>22 means. There are typically consolidating work papers that</p> <p>23 take balances off the general ledger, the various general</p> <p>24 ledgers and roll those into totals.</p> <p>25 Q All right. If I understand, you have journal entries,</p>	<p style="text-align: right;">Page 1542</p> <p>1 MR. SJOBLUM: I have no further questions, Your</p> <p>2 Honor.</p> <p>3 CROSS-EXAMINATION</p> <p>4 BY MR. HICKS:</p> <p>5 Q Good afternoon, Mr. Lamphron. My name is Bill Hicks.</p> <p>6 I represent the SEC in this case.</p> <p>7 Now, do I understand that your audits, including</p> <p>8 whatever you did in 2003 for year end 2002, you never found</p> <p>9 any asset numbers on the books that you determined to be</p> <p>10 fictitious?</p> <p>11 A That's correct.</p> <p>12 Q And would it be true to say that if your audit team</p> <p>13 looked into an asset to find what was behind a number and</p> <p>14 were provided with an invoice, that would generally be the</p> <p>15 end of it?</p> <p>16 A Generally, yes.</p> <p>17 Q And is it also true that you never, in any of your</p> <p>18 audits, found any cash numbers on the books that turned out</p> <p>19 to be fictitious?</p> <p>20 A That's correct.</p> <p>21 Q Now, in connection with the 2002 financials, just</p> <p>22 roughly what would have been the period of your audit in</p> <p>23 terms of the time you were actually working?</p> <p>24 A We would have, I believe, in 2002 in November,</p> <p>25 December, we did some preliminary work. And then in late</p>

<p style="text-align: right;">Page 1543</p> <p>1 January, early February, we got back in the field and  2 started on our year end work.  3 Q What steps did you take to confirm the reported  4 cash?  5 A We -- I'm not familiar -- I haven't looked back at our  6 work papers. I don't know what procedures we performed  7 specifically with respect to cash for the 2002 audit.  8 Q Did the changes to your audit practices that you  9 referred to on your direct have anything to do with  10 checking cash more closely or confirming more assets?  11 A As a practice, we've always -- we would typically  12 confirm cash, and that hasn't changed in the post-Enron  13 era.  14 Q As a general rule, is it your firm practice with  15 whatever company you're checking where they have a cash  16 number to go to the banks and confirm with the banks that  17 the cash is actually in the accounts?  18 A Typically, we would, although not all cash accounts.  19 If there were a number of cash accounts and some with some  20 very small balances, we might restrict the confirmation  21 process to those large, very active accounts with high  22 volume of activity, high balances, that sort of thing.  23 Q Now, in connection with your audit of the 2002  24 statements, as of what date did you confirm the cash?  25 A I don't recall.</p>	<p style="text-align: right;">Page 1545</p> <p>1 that's making that review.  2 THE COURT: Ernst &amp; Young's general counsel?  3 THE WITNESS: Yes.  4 Q There was some testimony in connection with Grand Jury  5 minutes about --  6 THE COURT: Grand Jury minutes?  7 MR. HICKS: I'm sorry, not Grand Jury minutes.  8 Corporate minutes. I misspoke.  9 Q The corporate minutes, in connection with your audits,  10 when you were done, you made presentations to the  11 HealthSouth board, is that correct?  12 A That's correct.  13 Q Had you received a management representation letter at  14 that time?  15 A At what time?  16 Q Before making those presentations.  17 A I don't know. I don't believe we have. I don't think  18 we have for the year 2002.  19 Q Now, you said in connection with the contractual  20 adjustment account that you were, I believe your words  21 were, satisfied with the balances; correct?  22 A That's correct.  23 Q What does that mean?  24 A That means in the context of auditing the financial  25 statements as a whole, we felt like they were, the overall</p>
<p style="text-align: right;">Page 1544</p> <p>1 Q I think there's been some testimony about a date at  2 the end of September. Would there be any reason for that?  3 A We're allowed, in the audit process, to perform  4 substantive audit procedures any time within six months of  5 year end, so it is not unusual to review certain balances  6 at a date other than the company's year end.  7 There are additional procedures that are then done to  8 roll forward and verify those balances from the  9 confirmation date to the report date, to the financial  10 statement date.  11 Q Checking with the banks?  12 A Reviewing bank statements, that sort of thing, yes,  13 reviewing reconciliations, bank reconciliations prepared by  14 the company.  15 Q Well, since this case has been filed, has E&amp;Y gone  16 back and determined what they did or failed to do in  17 connection with confirming the cash that HealthSouth was  18 reporting at year end?  19 A I haven't. I haven't reviewed our work papers. We  20 basically shut them down five weeks ago and I really  21 haven't had access since then.  22 Q Is someone inhouse doing that?  23 A Yes.  24 Q Who would that be?  25 A We have a team out of the general counsel's office</p>	<p style="text-align: right;">Page 1546</p> <p>1 financial statements were fairly presented and those  2 balances, while we don't audit those individual balances,  3 the audit procedures that we performed yield satisfactory  4 results or we felt the balances were reasonably correct,  5 materially correct.  6 Q You don't audit the individual balances?  7 A I said we don't audit individual accounts, that's  8 correct.  9 Q Is there more than one account that has contractual  10 adjustment information in it?  11 A Yes.  12 Q Now, it is fair to say, is it not, that prior to March  13 19th, no fraudulent practices at HealthSouth ever came to  14 your attention?  15 A There were instances -- well, we were aware of the  16 company's, some of their legal issues with some alleged  17 fraud with respect to Medicare billings. We were aware of  18 a settlement made in, I'm not sure if it was 2001 or 2002,  19 where the company made a settlement of about eight million  20 dollars with respect to some, what might have been termed  21 fraudulent billing activities. And we had -- there were  22 some allegations of some fraud that were -- that were  23 brought to our attention.  24 THE COURT: By whom?  25 THE WITNESS: We received an e-mail from a</p>

<p style="text-align: right;">Page 1547</p> <p>1 gentleman by the name of Vines that came into a firm  2 website and eventually filtered its way down to me.  3 Q What did that say?  4 THE COURT: Would that be Ernst &amp; Young's website  5 or --  6 THE WITNESS: An Ernst &amp; Young website. At our  7 national office, someone received that and then ultimately  8 tracked me down as a coordinating partner and got me that  9 message.  10 Q When was that?  11 A It was late June, early July of 2002.  12 Q What did it say?  13 A It alleged some fraudulent activities in some --  14 between some fixed asset accounts and some expense  15 accounts.  16 Q Would that be fixed asset accounts, AP accounts, AP  17 summary account?  18 A No, just actual fixed asset accounts.  19 Q You indicated that --  20 THE COURT: Did you do -- excuse me, Mr. Hicks.  21 Did you do anything about it?  22 THE WITNESS: Yes, we did.  23 THE COURT: And what did you do?  24 THE WITNESS: I, when initially receiving the  25 e-mail, I took it to our professional practice director or</p>	<p style="text-align: right;">Page 1549</p> <p>1 looked at those and one or two other accounts that were  2 similar. And we vouched some transactions and reached a  3 point where we were satisfied with the explanation that the  4 company had provided to us.  5 THE COURT: Who provided that explanation to you  6 from the company?  7 THE WITNESS: That was Bill Owens. And the  8 explanation was that the company has relatively tight  9 controls in place over the purchase of fixed assets. And  10 some of the field locations would sort of bypass or work  11 their way around that process by making purchases. They  12 would typically be capital purchases. Those would expense  13 those, which came under a different level of review, didn't  14 require preapproval, that sort of thing. Knowing this was  15 happening, the company made -- as reported to us by Bill  16 Owens, the company made a practice of regularly reviewing  17 certain repairs and maintenance accounts to see what maybe  18 should have been capitalized and then they would make  19 journal entries that would effectively capitalize those  20 purchases.  21 He indicated that that was a process that they  22 had been doing for several years and something that they  23 routinely did in addition to looking at the -- I believe we  24 looked at the year end 2001 balances for those accounts and  25 again vouched some of the transactions. We looked back at</p>
<p style="text-align: right;">Page 1548</p> <p>1 I called our professional practice director in Atlanta to  2 discuss the issue with him and we decided on a course of  3 action. The initial course of action entailed me making  4 contact with the company being the CEO, the CFO and the  5 chairman of the audit committee. I went to the CFO. We  6 talked about it. We contacted the chairman of the audit  7 committee.  8 THE COURT: You went to the CFO who was --  9 THE WITNESS: Bill Owens.  10 THE COURT: And you contacted who after that?  11 THE WITNESS: The chairman of the audit committee  12 George Strong. We talked about the allegation that was  13 made. We decided that the company would pursue it on their  14 end and that we would pursue it on our end doing some  15 audit-related procedures with respect to the three specific  16 accounts that he alleged were being misstated. And I --  17 members of our audit team executed those procedures.  18 It entailed -- the allegation itself was that  19 there was a misclassification between some asset and some  20 expense accounts. Specifically, that the company was  21 taking expenses that might typically be related to assets,  22 repairs, maintenance, that sort of thing, and was  23 capitalizing those costs as plant equipment.  24 They mentioned, I believe, it was three accounts.  25 He mentioned the specific account numbers. We went and</p>	<p style="text-align: right;">Page 1550</p> <p>1 some other years to see if the company had, in fact, made  2 similar adjustments in those years. They had.  3 And at that point, we were satisfied that we knew  4 why those entries were being made, the nature of those  5 entries and at the end of the day that those  6 reclassifications were correct.  7 The balances involved were in the three million  8 dollar range.  9 THE COURT: Let ask you something: Did Mr. Owens  10 ever make any comment about why Mr. Vines would make such  11 an accusation on your e-mail?  12 THE WITNESS: He indicated Vines was a former  13 employee who had been fired and they had had some  14 disciplinary problems prior to his being let go. And he  15 was a disgruntled employee and that's why he was bringing  16 that to our attention. Plus the fact that he may not have  17 actually understood why those adjustments were being made.  18 Q When you say you vouched some transactions, what does  19 that mean?  20 A That means that, again, we're dealing with items that  21 were initially recorded as an expense and then a journal  22 entry was made to capitalize them.  23 As an example, they may have bought a television for  24 one of their facilities, expensed it. And we would look at  25 the purchase vouchers, the payments for the television,</p>

<p style="text-align: right;">Page 1551</p> <p>1 piece of equipment or whatever it was and see, in fact,                  2 that it was a capital type item, see what they had paid for                  3 it and see that it was an item that should have in fact                  4 been capitalized to begin with.                  5 Q Where did you get the purchase vouchers?                  6 A We got them from the HealthSouth accounting staff.                  7 Q Did you ever --                  8 THE COURT: I'm not quite through with this topic                  9 yet. Okay.                  10 You're making this explanation in the fall of                  11 last year?                  12 THE WITNESS: In July --                  13 THE COURT: You said he e-mailed you late June or                  14 early July 2002.                  15 THE WITNESS: That's correct.                  16 THE COURT: I assume it was not an examination                  17 you could make that month?                  18 THE WITNESS: We did it within a two-week                  19 period.                  20 THE COURT: Okay. And you said you went back how                  21 many years?                  22 THE WITNESS: We went -- I'm not sure how many                  23 years. We looked -- with respect to the actual allegation,                  24 we looked at the 12-31-01 balances for those accounts. We                  25 then looked at several other periods. I'm not sure how</p>	<p style="text-align: right;">Page 1553</p> <p>1 A That's correct.                  2 Q You don't know if they were fake or real; correct?                  3 A That's correct.                  4 Q Mr. Owens told you that this had been going on for                  5 years, whatever "this" is; correct?                  6 A Yes.                  7 Q He told you also, did he not, that Mr. Vines had been                  8 fired, et cetera; correct?                  9 A That's correct.                  10 Q Did you ever look at Mr. Vines' personnel file?                  11 A No.                  12 Q You accepted Mr. Owens's representations?                  13 A That's correct.                  14 Q Now, it would be true, I suppose, I'm not an                  15 accountant, you can tell me if there's any qualifications,                  16 that if any of the money that we're talking about was                  17 actually used to purchase an asset, then it would be                  18 appropriate to move it over to the other account?                  19 A It would be appropriate to capitalize it, correct.                  20 Q And if not, it would not be?                  21 A That's right.                  22 THE COURT: Did you ever ask to see any checks                  23 for payment of those invoices?                  24 THE WITNESS: I didn't. I don't know if we --                  25 there are different levels of vouching. In some cases, we</p>
<p style="text-align: right;">Page 1552</p> <p>1 many specifically, but looked to see that similar type                  2 adjustments had been made.                  3 What we were trying to ascertain was, in fact,                  4 did a -- was Bill Owens' representation to us that they did                  5 this routinely, if that was in fact true.                  6 And from what we saw, they had been doing it on a                  7 fairly routine basis.                  8 We then concluded -- we then closed the process                  9 by me getting back to our technical people and ultimately                  10 sitting down with Bill Owens and communicating our findings                  11 to Bill and to George Strong, the chairman of the audit                  12 committee. And while I never spoke to Mr. Scrushy about                  13 it, Bill indicated, I felt it was important that he know                  14 about it and he indicated that he had, in fact, told him                  15 about the situation, had briefed him about it.                  16 Q Now, you said, invoice may be the wrong word, but you                  17 said you looked into some of the transactions and you were                  18 given some document by the accounting department.                  19 A We were given copies -- we were given invoices, yes.                  20 Q Did you make any attempt to see if any of those                  21 invoices were forged?                  22 A I have no knowledge that we would have done that.                  23 Q All right. So if I understand where you're coming                  24 from here, you looked into some transactions and you were                  25 given invoices by the accounting department; correct?</p>	<p style="text-align: right;">Page 1554</p> <p>1 might go to an invoice. In some cases, we might vouch it                  2 all the way down to a cancelled check.                  3 THE COURT: Right. I'm asking you, since you had                  4 been specifically made aware of an alleged fraud, did you                  5 -- and Mr. Owens told you that this has been going on for                  6 years, did you check any -- did you or your team check any                  7 invoices against any checks, supposedly paying those                  8 invoices?                  9 THE WITNESS: I don't know that we did that.                  10 THE COURT: Okay.                  11 Q Were all of the expense transfer issues below five                  12 thousand dollars?                  13 A I don't know what the level -- I just don't recall. I                  14 haven't looked back at those work papers. I know that in                  15 total the amounts reclassified for 2001 were in the three                  16 million dollar range.                  17 Q I'm talking about individual amounts.                  18 A I don't know.                  19 Q Did E&amp;Y have a threshold number below which they would                  20 not look at various items in connection with the audit?                  21 A In connection with our normal audit process?                  22 Q Well, at HealthSouth.                  23 A At HealthSouth? Yes. We would typically have                  24 vouching limits, areas -- limits in which we would -- below                  25 which we would or above which we would explore things,</p>

<p style="text-align: right;">Page 1555</p> <p>1 investigate them further, that sort of thing.                  2 Q And in connection with assets, what was the limit?                  3 A Well --                  4 Q And if it changed, say so.                  5 A They would be different for different types of assets.                  6 What those limits were for the 2002 audits, I don't know.                  7 I would -- I just don't recall right now. And again, I                  8 haven't looked back at our work papers.                  9 THE COURT: When you say limit, the thresholds                  10 would be different for different types of assets?                  11 THE WITNESS: That's correct.                  12 THE COURT: Like what?                  13 THE WITNESS: Well, if we were looking at their                  14 other investment account, their other investment account                  15 had a balance of maybe somewhere in the twenty-five, thirty                  16 million dollar range, we might have a limit there where we                  17 would look at -- well, in this case, in 2000, we looked at                  18 all the investments there and looked at their valuation                  19 techniques and tried to substantiate those values.                  20 THE COURT: What investments are you talking                  21 about?                  22 THE WITNESS: Investments in other companies, in                  23 common and preferred stock, that sort of thing.                  24 If we're looking at fixed assets, we might have a                  25 limit. It would be different for each different type of</p>	<p style="text-align: right;">Page 1557</p> <p>1 George Strong, they asked me to sort of close the loop, to                  2 get back to Vines and tell him that we had, in fact,                  3 received his e-mail, that we had looked into it and that                  4 we, you know, found nothing that was inappropriate.                  5 We had a telephone number that was on the e-mail                  6 that he had sent to us. I called that number on several                  7 occasions and was never able to talk to Vines.                  8 THE COURT: I thought you said you talked to him                  9 THE WITNESS: I said I attempted to try to talk                  10 to him.                  11 Q Have you maintained a copy of that e-mail?                  12 A Yes.                  13 Q And where is it?                  14 A It's with our work papers.                  15 THE COURT: Where are your work papers?                  16 THE WITNESS: They're in our office.                  17 THE COURT: Okay. Do you still have access to                  18 them?                  19 THE WITNESS: Yes, I have it. They have been --                  20 they're in our office. I can get access. I haven't made                  21 access to them. I mean, I haven't had a cause to go in and                  22 look at the work papers. And it's our preference that our                  23 general counsel's office look at them.                  24 THE COURT: Okay.                  25 Q When you initially contacted HealthSouth regarding</p>
<p style="text-align: right;">Page 1556</p> <p>1 asset. It depends on the nature of the account, the                  2 propensity --                  3 THE COURT: Let's just talk about fixed assets.                  4 Let's talk about the surgery table. Would there be a limit                  5 of five thousand? For example, you would not look at items                  6 that were bought, whether they were surgical tables or not,                  7 for that matter, that were under five thousand dollars in                  8 purchase price?                  9 THE WITNESS: I don't know what that limit is.                  10 There is a limit on all of those procedures or typically                  11 all those procedures below which we would not look, that's                  12 correct.                  13 THE COURT: Is there also a limit on what is                  14 considered -- is there -- well, let me just ask you if                  15 there are thresholds with respect to sizes of bank                  16 accounts.                  17 THE WITNESS: Yes.                  18 THE COURT: And do you know what those are?                  19 THE WITNESS: I don't know.                  20 THE COURT: Okay.                  21 Q Did you ever attempt to talk to Mr. Vines directly?                  22 A Yes, I did.                  23 Q And what happened?                  24 A The conclusion was made, after I reviewed with our                  25 organization and I reviewed our findings with Mr. Owens and</p>	<p style="text-align: right;">Page 1558</p> <p>1 this e-mail, did I understand you to say that you talked to                  2 the CEO, the CFO and the chairman of the audit committee?                  3 A No. I said I talked to our professional practice                  4 director and we mapped out what I should do, which was to                  5 talk to the CEO, the CFO and the chairman of the audit                  6 committee.                  7 I began that process by talking to Owens, and                  8 ultimately talked to Owens and Strong on several occasions.                  9 And as I previously said, I did not talk to Mr. Scrusby.                  10 This was right on the 4th of July vacation. I believe that                  11 he was traveling, I think was the situation. I asked Owens                  12 specifically when we got to the end of this process had he                  13 talked to Richard Scrusby about it, he indicated he had.                  14 He had apprised him of it and the results of our review.                  15 Q You also said in response to a question that prior to                  16 the filing of this complaint in connection with all your                  17 audits and encounters, that you have no basis or nothing                  18 ever jumped out at you that led you to the conclusion that                  19 Mr. Scrusby was involved in accounting fraud at                  20 HealthSouth?                  21 A That's correct.                  22 Q Did anything ever leap out at you that led you to the                  23 conclusion that Mr. Owens was involved in accounting fraud                  24 at HealthSouth?                  25 A No.</p>

<p style="text-align: right;">Page 1559</p> <p>1 Q How about Weston Smith?                  2 A No.                  3 Q Emery Harris?                  4 A No.                  5 Q Cathy Edwards?                  6 A No.                  7 Q Anybody?                  8 A No.                  9 MR. HICKS: Can I just have a minute?                  10 (Brief pause)                  11 MR. HICKS: Nothing further.                  12 THE COURT: Let me ask you something. If, in                  13 fact, it was going on, what Mr. Vines said in his e-mail to                  14 you in June, July of 2002, Mr. Owens assured you it was not                  15 going on, what would be your conclusion from that?                  16 THE WITNESS: Well, we didn't rely on Mr. Owens'                  17 representation.                  18 THE COURT: I didn't ask you that.                  19 THE WITNESS: Okay. I'm not following your                  20 question.                  21 THE COURT: I said if, in fact, the fraud was                  22 going on, as described by Mr. Vines, and Mr. Owens assured                  23 you it was not going on, do you have a conclusion with                  24 respect to Mr. Owens based on that?                  25 THE WITNESS: I had nothing to think he was</p>	<p style="text-align: right;">Page 1561</p> <p>1 Q And when did you conclude your review?                  2 A I think it was around July 13th.                  3 Q When you finished?                  4 A Right.                  5 Q I believe you also testified that Mr. Owens told you                  6 that Mr. Scrusy was out of town; right?                  7 A I said I thought that's what he said and he was                  8 unavailable during that period of time.                  9 Q You don't know whether or not Mr. Owens, in fact, told                  10 Mr. Scrusy, do you?                  11 A I do not.                  12 Q Now, you mentioned some issues over Medicare payments,                  13 settlements, that type of thing. Let me show you --                  14 MR. SJOBLOM: Judge, I know those exhibits have                  15 been passed out. I no longer have them. But I have a                  16 copy, it's Exhibit 31, which is notes of a meeting with HRC                  17 management, September 3, 2002.                  18 Would you take a look at that and see if you                  19 recognize that document?                  20 A I've never seen this document before. Well, excuse                  21 me. I do recognize the document.                  22 Q Is it an E&amp;Y work paper of some sort, an E&amp;Y work                  23 paper or memo of some sort that has transmittal 1753                  24 attached to it?                  25 A Yes. It is a summary memo with 1753 attached.</p>
<p style="text-align: right;">Page 1560</p> <p>1 involved in any fraud.                  2 THE COURT: But he did assure you that it was not                  3 going on?                  4 THE WITNESS: The situation that Vines described                  5 was, in fact, happening. They were making                  6 reclassifications of balances from repair and maintenance                  7 accounts to fixed asset accounts. So what he said to us in                  8 the e-mail was happening was, in fact, happening.                  9 Our procedures determined that there was no                  10 problem with what they ultimately did.                  11 THE COURT: Is that still your conclusion?                  12 THE WITNESS: That's still our conclusion.                  13 THE COURT: Okay. Thank you.                  14 REDIRECT EXAMINATION                  15 BY MR. SJOBLOM:                  16 Q With respect to this topic of your conversation with                  17 Mr. Owens, you indicated you wanted to talk to the CEO, the                  18 CFO -- and I forget who the --                  19 THE COURT: The chairman of the audit                  20 committee.                  21 Q The chairman of the audit committee, Mr. Strong. And                  22 this is late July, early August, 2002?                  23 A This is late June, early July.                  24 Q Is when this occurs?                  25 A Yes.</p>	<p style="text-align: right;">Page 1562</p> <p>1 MR. SJOBLOM: We would offer Defendant's Exhibit                  2 31, Your Honor.                  3 THE COURT: It's admitted.                  4 Q Mr. Lamphron, this document indicates on September 3,                  5 2002, you, together with Mr. Dunn, a senior manager, Mr.                  6 Mills, a manager, met with Weston Smith and Emery Harris to                  7 discuss the reduced reimbursement on physical therapy; is                  8 that correct?                  9 A That's correct.                  10 Q What was discussed at that meeting?                  11 A The nature -- well, what the basic issue was, why                  12 there -- what 1753 addressed, what changes it would make in                  13 their billing processes and ultimately talked about had                  14 they quantified the effect of that change.                  15 Q Does this memo also in chronological order describe                  16 what took place in July, August of 2002 to arrive at a                  17 number of impact? Look at the middle paragraph of Exhibit                  18 Number 31.                  19 A That is a description of what Weston Smith described                  20 to us was the chronology of events surrounding the                  21 transmittal 1753.                  22 Q Who is Mr. Dunn and Mr. Mills?                  23 A Wayne Dunn is a senior manager with us that works on                  24 the audit engagement and Mills is Michael Mills, a manager                  25 with Ernst &amp; Young.</p>

<p style="text-align: right;">Page 1563</p> <p>1 Q Okay. This last sentence on Exhibit 31 talks about an 2 August 20th date when a press release was made by 3 HealthSouth. Do you know when, in fact, a press release 4 went out by HealthSouth? 5 A I don't know, in fact, when it went out. 6 Q Could it have been August 27th instead of August 7 20th? 8 A I don't know for a fact that that August 20th date is 9 accurate or not. I assume it would be, but I don't know 10 that for a fact, no. 11 Q Do you recall in general what Mr. Weston Smith told 12 you about the impact of 1753? 13 A The general nature of the discussions were that there 14 existed a great deal of confusion among the providers of 15 rehabilitation services as to the nature of how billings 16 might occur involving either individual or group therapy. 17 And cited an example of what he was talking about. 18 And then went on to say that 1753 -- he recited 19 how 1753 came to their attention, how they initially 20 thought it didn't apply, how they got some confirmation 21 from a third party, I believe, some correspondence may have 22 gone back and forth between the company and Blue Cross. 23 And they finally became aware that it did, in fact, apply 24 to them and that it would, in fact, have financial 25 implications to them. And he estimated a hundred and</p>	<p style="text-align: right;">Page 1565</p> <p>1 THE COURT: He asked if he agreed with Mr. 2 Horton's assessment. Overruled. 3 A I think that that memo accurately reflects where we 4 were in the thought process and that we were -- we were at 5 the time -- the best I can recall at the time the 10-Q was 6 filed this issue had sort of just surfaced, we were trying 7 to figure out what the implications might be, that sort of 8 thing. We felt that -- and they didn't want to put 9 specific numbers in the 10-Q at the time because they were 10 still doing further quantification, that sort of thing. 11 MR. SJOBLUM: Just a moment, please. 12 (Brief pause) 13 MR. SJOBLUM: I have no further questions, Your 14 Honor. 15 THE COURT: I think that was admitted 16 yesterday. 17 MR. SJOBLUM: Pardon me? 18 THE COURT: That has already been admitted. I 19 think that was admitted yesterday. Do you have 31 20 previously admitted? 21 THE CLERK: No, ma'am. 22 THE COURT: Anything else for you, Mr. Hicks? 23 MR. HICKS: I just have a few more questions. 24 RE-CROSS EXAMINATION 25 BY MR. HICKS:</p>
<p style="text-align: right;">Page 1564</p> <p>1 seventy-five million dollar impact. 2 Q And that's the number that was published in the press 3 release on August 27th? 4 A That's correct. 5 MR. HICKS: Your Honor, I object to this line of 6 questioning, it's outside the scope of my cross. 7 MR. SJOBLUM: You opened the door. You asked him 8 about Medicare fraud. 9 THE COURT: Overrule the objection. 10 Q At the end of Exhibit Number 31, Ernst &amp; Young 11 representatives state that they inquired of Mr. Horton 12 about the 10-Q disclosures for, that would be the second 13 quarter of 2002, to be filed by August 15, 2002. 14 Now, Mr. Horton related that there was no 15 definitive information and, therefore, no disclosure would 16 be required for something they did not know definitively by 17 August 15, 2002. 18 Do you recall that? 19 A I recall having discussions with Bill Horton about the 20 nature of the disclosures for the second quarter 10-Q, yes, 21 I do. 22 Q Do you disagree with Mr. Horton's conclusion at the 23 bottom of Exhibit 31 of what the company knew as of the 24 second quarter? 25 MR. HICKS: Objection, calls for speculation.</p>	<p style="text-align: right;">Page 1566</p> <p>1 Q In connection with the Vines situation which was in 2 July, August of 2002; correct? 3 A It was in late June, early July of 2002. 4 Q All right. Did you actually talk to the CFO at that 5 time? 6 A Yes, I did. 7 Q And who do you think was the CFO at that time? 8 A Well, I talked to Bill Owens at the time. 9 Q Well, if I was to tell you Weston Smith was the CFO, 10 you would not have talked to the CFO; correct? 11 A That would be correct. I don't recall having -- 12 MR. SJOBLUM: Objection, it misstates what the 13 evidence is. 14 MR. HICKS: Here's their chart. 15 MR. SJOBLUM: It's June, July of 2002. 16 MR. HICKS: You can look on their chart. 17 THE COURT: Let me just tell you, unless I have 18 been sleeping the last ten days, Mr. Owens became the CEO 19 of HealthSouth on August the 26th, 2002 and he was approved 20 by the board on August the 8th, 2002. 21 MR. HICKS: That's not correct, Your Honor. Mr. 22 Smith was the CEO from August 2000. 23 THE COURT: Now, sir, you may not testify. If 24 I'm mistaken about the record, I will certainly clarify 25 when I reread the transcripts. But I think there are board</p>

<p style="text-align: right;">Page 1567</p> <p>1 minutes to that effect of what I just said. If it will 2 make you feel better, I will be glad to find them. 3 MR. HICKS: I was just looking at the defendant's 4 chart. Maybe I shouldn't have relied -- 5 MR. SJOBLOM: It just has the month, it doesn't 6 have the date. 7 THE COURT: What's your next question? 8 Q In connection with the 1753 issue and the conclusion 9 about where you all were in terms of what you knew, was 10 your knowledge about what Bill Owens or any of the other 11 executives knew based on what they told you they knew? 12 A Well, they certainly told us -- ask the question 13 again, I'm sorry. 14 Q You're not a mind reader, in other words? 15 A I am not a mind reader. 16 Q So when you talk about what they knew -- Owens, Smith, 17 Scruschy, anybody -- you're relying on what they tell you? 18 A That's exactly right. 19 MR. HICKS: Nothing else, Your Honor. 20 THE COURT: Okay. Hang on just a second. 21 (Brief pause) 22 THE COURT: Mr. Hicks, would you approach the 23 bench, please? 24 MR. HICKS: I will. 25 THE COURT: And I need to see counsel from the</p>	<p style="text-align: right;">Page 1569</p> <p>1 with the U.S. Attorney's office, and we ask to be allowed 2 to orally amend our motion to include Mr. McVay in our 3 objection that no witness is to be asked any questions 4 regarding the ongoing criminal investigation. 5 THE COURT: I'm not going to grant that at this 6 time. Mr. McVay's represented by counsel. You may 7 proceed. 8 MALCOLM EERVIN MCVAY, DEFENDANT'S WITNESS, SWORN 9 THE CLERK: Would you state your first and last 10 name. 11 THE WITNESS: Malcolm McVay. 12 THE CLERK: Will you spell your last name? 13 THE WITNESS: M-c-V-a-y. 14 THE CLERK: In what city and state do you reside? 15 THE WITNESS: Mountain Brook, Alabama. 16 THE COURT: Do you have a middle name? 17 THE WITNESS: Eervin, E-e-r-v-i-n. 18 THE COURT: E-e-r-v-i-n? 19 THE WITNESS: Correct. 20 DIRECT EXAMINATION 21 BY MR. SJOBLOM: 22 Q Mr. McVay, my name is Thomas Sjoblom. I represent Mr. 23 Scruschy in this matter. You, sir, and I have never met 24 before, have we? 25 A I don't believe so.</p>
<p style="text-align: right;">Page 1568</p> <p>1 other side, too. 2 (Bench discussion off the record) 3 THE COURT: I need to see you at side bar. 4 (Side bar discussion off the record) 5 THE COURT: You're excused. 6 THE WITNESS: Thank you. 7 THE COURT: Do you have another witness? 8 MR. SJOBLOM: Yes, we do. 9 THE COURT: Okay. 10 MR. SJOBLOM: The defense would call as their 11 next witness Mr. Tad McVay. 12 THE COURT: All right. 13 MR. SMITH: May I approach, Your Honor? 14 THE COURT: Yes. 15 (Bench discussion off the record between the 16 Court and Mr. Richard Smith.) 17 THE COURT: Would you let the record show that 18 Mr. McVay -- you're Mr. McVay? 19 THE WITNESS: Yes. 20 THE COURT: -- is on the stand, and his attorney, 21 Don Frost, is behind him. You need to speak up so she can 22 hear you. 23 MR. SMITH: I would like to bring to the Court's 24 attention that Mr. McVay does, in fact, have knowledge of 25 the ongoing criminal investigations and is in discussions</p>	<p style="text-align: right;">Page 1570</p> <p>1 Q Prior to this moment, have we ever been introduced to 2 each other, had a conversation? 3 A I don't -- no. 4 Q I will assure you I've never been in the City of 5 Birmingham until this proceeding started. Can you give me 6 your education, Mr. McVay? 7 A High school graduate. Then graduated from the 8 University of the South. 9 Q Mr. McVay, what year did you get your high school 10 degree? 11 A 1980. 12 Q And you graduated from University of the South when? 13 A 1984. 14 Q With a degree in what? 15 A English. 16 Q What year? 17 A 19 -- 18 Q 1984. I'm sorry. Okay. Any other advanced degrees 19 or master's degrees? 20 A A master's from the University of North Carolina in 21 Business Administration. 22 Q MBA? 23 A Yes. 24 Q What year? 25 A 1987.</p>