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MEMORANDUM

TO: David Barrack

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

(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 21st Century Health Venture L.L.C. which went out of business causing a loss on the loan. Money that went to 21st 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.

- - 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 Scrushy, valued at $10.06 per share, in repayment of a loan. The valuation was excessive and unreasonable given what Scrushy 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. <u>The Timeline for the Securities Fraud Claims</u>

12/14/2001	• HealthSouth press release projected EPS of $1.14 in 2002. • Scrushy 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."
1/14/2002	• HealthSouth press release stated that the company is comfortable with an estimate of $1.14 EPS for 2002. • The release stated that HealthSouth expected a positive impact from the implementation of the new PPS. • Scrushy said: "We have been preparing for the implementation of PPS for several years. . . this new system is not a surprise, and our intensive

	cost management efforts have prepared us well for it."
1/22	• HealthSouth press release stated that the Company had received notification of its first PPS payments. • According to the press release, the payments were "identical to the expected payment predicted by HealthSouth's internal PPS payment model." • Scrushy 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." • Scrushy reaffirmed the earnings guidance of $1.14 EPS.
2/14	• HealthSouth director George Strong sold 73,885 shares for proceeds of $895,121
3/12	• HealthSouth press release announced fourth quarter results. Scrushy said: "our early experience under the new impatient rehabilitation prospective payment system is confirming our expectations for the positive impact that PPS will have on our business."
3/27	• HealthSouth filed its Form 10-K which stated: "freestanding impatient 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. • The 10-K stated: "we believe that our low-cost profile favorably positions us to respond to reimbursement pricing pressure."
5/2	• HealthSouth press release announced first quarter earnings consistent with consensus estimates. • Scrushy 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."
5/10	• HealthSouth filed its Form 10-Q for the first quarter.

5/14	•	Scrushy 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.
5/17	•	As alleged in ¶ 28 of the Strauss 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."
	•	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."
	•	According to paragraph 27 of the Strauss 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).
	•	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).

	***	**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.**
6/7	•	Strong sold 66,665 shares for proceeds of S933,310.
6/11	•	Strong sold 67,216 shares for proceeds of S941,024.
7/11	•	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."
7/29	•	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.
7/31	•	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.
	•	As a result of the May sale and the July transfer, Scrushy disposed of 75% of his interest in HealthSouth.
8/7	•	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."
8/8	•	A management sponsored conference call gave no hint of PPS adversely impacting HealthSouth's revenues or earnings.
8/12	•	Follow-up article in Barron's described HealthSouth as a health-care business at a "bargain price."
8/14	•	HealthSouth filed its Form 10-Q for the second quarter.
	•	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.
	•	HealthSouth filed Form 8-K to comply with SEC Order 4-460.

	Scrushy and the CFO certified the company's results.
8/26	• 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.
8/27	• 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. • 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." • The press release stated: "the directive implemented on July 1 is inconsistent with many providers' understanding of appropriate coding practices."
8/27-28	• News media reported CMS directive was no surprise to industry insiders who knew about it for months. • Analysts downgraded HealthSouth and question management's credibility. • Rating agencies put HealthSouth on CreditWatch. • CMS Administrator was quoted in Reuters that he is "astounded" by the claims in HealthSouth's press release. • 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.