UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ALABAMA
SOUTHERN DIVISION

In re HEALTHSOUTH CORPORATION SECURITIES LITIGATION This Document Relates To: ALL ACTIONS.	Master File No. CV-03-BE-1500-S
In re HEALTHSOUTH CORPORATION STOCKHOLDER LITIGATION This Document Relates To: ALL ACTIONS.	Consolidated Case No. CV-03-BE-1501-S
In re HEALTHSOUTH CORPORATION BONDHOLDER LITIGATION This Document Relates To: ALL ACTIONS.	Consolidated Case No. CV-03-BE-1502-S CLASS ACTION

AMENDMENT TO JOINT SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS
[FACTUAL BASIS]

INTRODUCTION

1. Pursuant to the Court's direction at the June 28, 2006 hearing, the Stockholder Plaintiffs and the Bondholder Plaintiffs respectfully submit this AMENDMENT TO JOINT SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS [FACTUAL BASIS] (the " SAC"). Paragraphs 2-58 contain new allegations demonstrating that the UBS Defendants and E&Y committed deceptive acts whose primary purpose and effect was to create a false appearance of fact as part of a scheme to defraud. These allegations supplement the allegations contained in the SAC. In ¶¶2-58, any reference to or repetition of allegations in the SAC is to put the new allegations in context. Paragraphs 320A-371A replace paragraphs 320-330 and 366-416 of the SAC.

The UBS Defendants and E&Y's Activities Operated as a Scheme to Defraud HealthSouth's Investors

2. The UBS Defendants and E&Y, in concert with HealthSouth Corporation ("HealthSouth" or the "Company"), Scrushy and other senior officers and directors at HealthSouth, perpetrated an elaborate scheme to deceive HealthSouth's investors as to HealthSouth's financial results, business performance and future prospects. The UBS Defendants and E&Y each committed deceptive acts whose primary purpose and effect was to create a false appearance of fact in furtherance of the scheme, specifically to create the illusion that HealthSouth's reported revenue, income and earnings were the actual results achieved by HealthSouth's legitimate business activities. The deceptive actions undertaken by the UBS Defendants and E&Y permitted false and misleading information about HealthSouth's operations and finances to be incorporated into the price of HealthSouth's securities and relied upon by HealthSouth's investors ultimately causing loss and economic damage when reduced expectations presented a truer picture of the Company's prospects removing earlier inflation.

The UBS Defendants' Role in the Scheme

3. The UBS Defendants' conduct described in the SAC and this Amendment, demonstrates that the UBS Defendants engineered and directed a scheme that deceived the investing public regarding HealthSouth's true financial condition. The principal purpose and effect of the UBS Defendants' activities was to create the false appearance of HealthSouth's financial vitality and deceive HealthSouth's investors into believing that the Company was a growing, thriving business.

4. Citi and then UBS and its bankers were involved in the core aspects of the fraudulent scheme, as detailed below. In summary, these included:

(a) **Acquisitions**. UBS's bankers first with Citi until mid-1999 and then with UBS from mid-1999 until March 2003, identified targeted companies for the principal purpose and effect of washing HealthSouth's fraud off its books and then controlled the flow of information between HealthSouth and the target that could have revealed the fraud.

(b) **Integrated Public Offerings**. UBS's bankers structured the Integrated Public Offerings to evade SEC scrutiny, due diligence and strict liability under the Securities Act.

(c) **Public Statements**. UBS and its bankers issued dozens of public statements in analyst reports giving a glowing assessment of HealthSouth's operations, finances and future business prospects completely contrary to UBS's own internal analysis and in furtherance of the fraudulent scheme.

(d) **Repurchases**. In late 1998 through 1999 at the direction of McGahan and Lorello, first at Citi and then in mid-1999 at UBS, HealthSouth purchased more than 36.3 million shares of HealthSouth stock using $256 million in corporate cash to prop the price up knowing the stock price was already inflated. This occurred again in 2002 just after UBS helped Scrushy unload 5.2 million shares despite internal concerns about a loss on the transaction. Then, UBS again

directed HealthSouth to repurchase nearly 4 million shares at inflated prices using nearly $20 million in cash.

(e) **Other Financing**. UBS and its bankers provided other financing to HealthSouth including a commercial line of credit while, again attempting to control the flow of information to other banks. In late 2002 UBS's McGahan went so far as to provide a script to former HealthSouth CFO McVay concerning questions from other bankers about the need for a $1.25 billion line of credit with $400 million in cash supposedly on hand.

(f) **SPEs and Lease Accounting**. Through the use of Special Purpose Entities ("SPE"), UBS concealed HealthSouth's true level of debt which should have been (but was not) included on HealthSouth's financial statements due to guarantees UBS required from HealthSouth.

(g) **Campaign Contributions**. UBS and its bankers were so intertwined with HealthSouth that investment banking fees were used as political bribes at Richard Scrushy's request in furtherance of the fraud occurring at HealthSouth.

Acquisitions Were Used to Wash Through Fraud

5. Defendants McGahan and Lorello, first at Citi/Salmon until mid-1999 and then with UBS, were involved in every HealthSouth acquisition from 1987 forward. Indeed, in the mid-1990's, McGahan told Martin to "bake the earnings" for several quarters. McGahan told Martin HealthSouth could use up to 5% of the transaction costs to pad earnings.

6. According to defendants Martin, Owens and Smith, each acquisition from at least 1995 forward was conducted with little or no due diligence. Martin, Owens and Smith all participated in discussions with McGahan outlining the type of information that HealthSouth could not provide in due diligence. Owens specifically told McGahan that HealthSouth could not ask for certain information routinely exchanged during acquisition due diligence from targeted companies because HealthSouth could not provide similar information, such as monthly financial statements,

financial schedules and internal accounting documents. Such information could have revealed the Financial Fraud. As McGahan and Lorello did with the Integrated Public Offerings, in each acquisition, McGahan would prevent the flow of certain information to an acquisition target during due diligence.

7. This type of deceptive activity by Citi and then UBS and its bankers, according to defendant Martin, began at least as early as the fall of 1995 as HealthSouth was acquiring Surgical Care Affiliates ("SCA"). McGahan, then with Citi/Salomon, worked directly with Martin and others representing HealthSouth in the SCA acquisition. During the course of the due diligence, the investment bankers for SCA requested routine financial and accounting information from HealthSouth that would have exposed the Financial Fraud. Martin told McGahan that HealthSouth could not provide the detailed facility information requested and instructed McGahan to convince SCA to drop their request or cancel the deal. According to Martin, McGahan – who was Martin's close friend and to whom he spoke daily – understood why HealthSouth could not provide the financial and accounting information requested and succeeded in getting SCA's investment bankers to move forward without the requested information. This course of conduct continued on, as required, for all the remaining HealthSouth acquisitions.

8. McGahan engaged in the deceptive activity of preventing information flow to targets from that point through 1999 (when McGahan's deceptive conduct continued on with the Integrated Public Offerings), including the following transactions:

Jan 1996	Acquisition of Surgical Care Affiliates	$1,400,000,000
Mar 1996	Acquisition of Advantage Health	345,000,000
Aug 1996	Acquisition of Professional Sports Care	70,000,000
Dec 1996	Acquisition of ReadiCare	70,000,000
Mar 1997	Acquisition of Health Images	270,000,000
Oct 1997	Acquisition of ASC Network	185,000,000
Oct 1997	Acquisition of Horizon/CMS Healthcare	1,650,000,000
Jun 1998	Acquisition of The Company Doctor	25,000,000
Jul 1998	Acquisition of 33 Surgery Cntrs from HCA	500,000,000
Jul 1998	Acquisition of National Surgical Centers	590,000,000
Jul 1999	Acquisition of American Rehab. Services	50,000,000
Total		$5,155,000,000

9. Owens attended many meetings with McGahan in connection with every one of the many stock-for-stock acquisitions HealthSouth completed between 1995 and 1999, including the Company's major transactions with Horizon/CMS and others. During those meetings, Owens either told, or witnessed others telling, McGahan that HealthSouth could not ask any target company for certain due diligence information customarily exchanged in such deals because HealthSouth could not risk that the target company would seek the same due diligence information from HealthSouth. These intentionally "excluded" due diligence matters were so integral to the businesses of HealthSouth and the target companies that their exclusion, out of expressed fear that HealthSouth would have to reciprocate, had McGahan not known of the fraud would have compelled him to inquire further and end his own deceptive conduct. According to Martin and Owens, McGahan never expressed surprise at the repeated requests to conceal information.

10. Citi and UBS and its bankers not only prevented the flow of damaging information in acquisitions and the Integrated Public Offerings, McGahan also knew when selecting a target company that the main purpose for an acquisition was to allow HealthSouth to wash the financial fraud off its books using the targeted acquisitions. In early 1997, according to Martin, he and McGahan specifically discussed how HealthSouth would use the pending merger with Horizon (which was announced in February 1997) to pad HealthSouth's numbers.

11. To that end, in the summer of 1997, McGahan set the stage for selling the nursing home facilities HealthSouth would acquire in the Horizon merger to Integrated Health Services ("IHS") for $1.25 billion. This mid-summer agreement to sell the nursing home facilities on a yellow sheet of paper kept by McGahan destroyed the acquisition's tax free status, and if it had become public would have caused the entire transaction to unwind. Then, two weeks after completing the Horizon merger, HealthSouth completed the sale of the Horizon nursing home facilities to IHS. The Horizon merger and IHS sale allowed HealthSouth to wash $414 million of fraud off HealthSouth's books. As noted in the SAC, the Special Audit Review Committee ("SARC") report stated that rather than properly accounting for the sale to IHS, the Company took advantage of a favorable business opportunity to hide fraud. Through a complex series of book entries, the Company accounted for the acquisition and related sale of Horizon/CMS facilities by recharacterizing $414 million, previously recorded in a suspense account, as assets sold to IHS. According to the SARC report, no support for this entry existed. Instead, the $414 million simply represented a portion of the Company's overstatement of income in earlier periods.

12. While UBS has argued that its bankers were involved in only one transaction not barred by the statute of limitations, the orchestration of the earlier acquisitions goes to knowledge, intent, preparation and plan for their direct involvement in other aspects of the scheme. Further, the one remaining acquisition distorted HealthSouth's earnings for at least the next two years. Contrary to UBS' argument, the use of acquisitions to wash the fraud off HealthSouth's books and conceal the fraud continued to have a material impact on the financial condition of the Company and investors after July 30, 1999. Without UBS's manipulative conduct, the fraud would have been revealed earlier and investors who purchased at the stock after July 30, 1999 would not have purchased inflated shares.

13. The SARC report found that HealthSouth's June 1999 acquisition of outpatient rehabilitation centers from the American Rehability Services division of Mariner Post-Acute Network, Inc. ("Rehability") – an acquisition in which UBS and its bankers were the investment bankers advising HealthSouth and which is not barred by this Court's earlier rulings – was used to falsely inflate 2000 income. The Committee determined that the Company recorded an accounts receivable allowance for Rehability of $7 million more than the allowance reflected on Rehability's books. The additional $7 million, for which the Committee could find no support in the Company's accounting records, was released into earnings during 2000 and 2001, thereby improving HealthSouth's reported operating income.[1]

14. Further, the active involvement in canceling the HCR-Manor Care acquisition by McGahan in mid-summer 1999 to further the concealment of the fraud and subsequent announcement of the intended spin-off of the Surgery Center Division in 2002 were also part of the fraudulent scheme which impacted shareholders. McGahan was always looking for opportunities even when his close friend Martin could no longer carry out the scheme. As noted in an October 2001 e-mail from McGahan to Owens, "lastly, other opportunities (M&A). When do we play offense again?"

The Debt Offerings Increase in Size and Frequency as the Acquisition Spree Cools

15. Within months of the closing of the Horizon merger and the sale to IHS of the Horizon nursing home facilities, Lorello and McGahan devised a way for HealthSouth to raise the capital necessary to continue the façade of HealthSouth as a healthy, robust company by issuing debt

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[1] The SARC also noted that HealthSouth appears to have recorded additional reserves in order to avoid reducing reported income: For example, between 1997 and 2002, approximately $24 million of acquired facility reserves were improperly reclassified - generally in round dollar amounts not exceeding $150,000 - to an accrued bonus payroll general ledger account, thereby avoiding the recognition of bonus expense as a reduction to reported income.

in a Rule 144A exchange offering. As described more fully in ¶¶350A-363A below, the use of the Rule 144A exchange structure was undertaken solely to avoid detection of the financial fraud by the SEC and HealthSouth's investors, and to strip purchasers of the near-strict civil liability remedies available under the Securities Act. As set forth below in ¶357A, on March 6, 1998, Lorello and McGahan (of Salomon Barney Inc.) presented "for the Board's consideration a proposal from [HealthSouth] to raise additional capital through a debt offering" with a Rule 144A exchange structure. Martin asserts that McGahan's major selling point for switching to this structure was that it would avoid unnecessary SEC scrutiny.

16. As they had with the acquisitions, Lorello and McGahan controlled the information made available to the other underwriters participating in the Integrated Public Offerings by thwarting any questions posed by those underwriters that might have disclosed the fraud. If Lorello and McGahan had not stonewalled the usual and ordinary exchange of information with the other underwriters participating in the Integrated Public Offerings, and had those underwriters not been satisfied with incomplete information, the Integrated Public Offerings would not have been completed. The capital realized from the Integrated Public Offerings fed HealthSouth's coffers and permitted the defendants to continue to deceive HealthSouth's investors as to the true financial state of affairs at HealthSouth and keep the price of HealthSouth's securities inflated.

17. While the Integrated Public Offerings provided the capital needed for HealthSouth to operate and for the UBS Defendants to fool investors into believing that HealthSouth was financially sound, Lorello and McGahan continued their efforts to find an acquisition that would wash more of the financial fraud off HealthSouth's books. According to Martin, in the summer of 1998, McGahan and Martin, while sitting in the kitchen at Martin's home, discussed HealthSouth's need for an acquisition to hide the Financial Fraud so that HealthSouth would not miss Wall Street analysts' earnings estimates. The UBS Defendants identified Tenet Healthcare Corporation ("Tenet") and

HCA/Columbia Healthcare Corporation as potential acquisition targets. McGahan arranged meetings with each company, but neither was a good fit with HealthSouth. During this time, McGahan and Martin discussed almost daily the need to locate another acquisition target.

18. Martin and Owens knew that Scrushy wanted to wait 12 months before lowering expectations due to his late 1997 stock sales, believing the year timeframe would prevent inquiry and potential liability for insider selling. In September 1998, Martin told Geoff Harris, an analyst then with McGahan at Citi, that HealthSouth was experiencing pricing pressures from managed care contracts and might have to lower 1999 estimates. Harris issued a report. In this report, he cut estimates by $0.10/share. The stock price dropped from the mid-teens to around $10/share. While Scrushy and Martin believed Harris had jumped the gun and were angry, expectations had to be lowered further using the Balanced Budget Act ("BBA") as cover.

19. The UBS Defendants' efforts to find a suitable acquisition partner for HealthSouth intensified in early 1999. According to Martin, in January or February 1999, Martin and McGahan again discussed HealthSouth's deteriorating financial results, specifically, that HealthSouth was missing its revenue estimates by more than $10 million per week. McGahan and Martin were to go to a basketball game, but instead canceled those plans and discussed ways in which HealthSouth could get out of the present jam and avoid lowering, or missing, its earnings estimates. Again the focus of their discussions was finding a suitable acquisition that would hide the financial fraud.

20. In the early Spring 1999, Martin spoke with McGahan and Scrushy about alternatives to clean up HealthSouth's books. McGahan and Lorello were transitioning to UBS from Citi/Salomon, the UBS Defendants identified HCR-Manor Care as a potential acquisition target for HealthSouth ran a model on paper to see the mergers' benefits to HealthSouth. This potential acquisition was large enough such that hundreds of millions of dollars in fraud could be wiped off HealthSouth's books. McGahan set up an initial call between the CEO of HCR-Manor Care and

Scrushy. As time passed, however, Martin grew more concerned that proceeding with the acquisition would expose the fraud. As set forth in SAC ¶18(a), Martin convinced McGahan that the fraud had grown to such an extent that even minimal due diligence would expose the fraud, and they worked together to convince Scrushy that HealthSouth should not complete the acquisition.

21. Between July 1999 and May 2002, the UBS Defendants completed four Integrated Public Offerings, feeding nearly $2.5 billion of capital into HealthSouth. As set forth below in ¶¶350A-363A, each of these offerings was an illegitimate transaction, done for the express purpose of hiding and continuing the Financial Fraud and evading near-strict liability of the Underwriter Defendants under the Securities Act.

UBS's Public Statements to the Market Were False and Misleading and Contrary to Internal Beliefs

22. From mid-1999 until March 2003, the UBS Defendants also took affirmative measures to issue false and misleading statements about HealthSouth directly to the market. According to Martin, UBS participated in determining the quarterly conference call agendas. According to Martin, when Lorello and McGahan moved to UBS from Citi/Salomon in the spring of 1999, they invited HealthSouth to help pick the equity analyst that would issue research reports on HealthSouth to the market. At first, Will Hicks was suggested. Hicks interviewed, was offered a tremendous deal, but turned the job down when McGahan said that he, McGahan, would be determining the ratings and that Hicks would be immediately publishing a strong buy recommendation. Today Hicks would say, "he jumped out of the frying pan and into the fire" when he returned to Birmingham to work with HealthSouth. Howard Capek was eventually chosen by HealthSouth to be their analyst. Immediately upon being hired by UBS, Capek issued two favorable

reports in May and June 1999. *See* App. 6.[2] However, Capek ceased issuing reports in the summer and fall of 1999 due to the "quiet period" imposed on his coverage because of UBS's involvement in the potential HCR-Manor Care acquisition and subsequently into the fall of 1999 because of discussions of splitting off HealthSouth's inpatient facilities. During this time, even though his bank was identifying acquisition targets for HealthSouth, Capek privately referred to HealthSouth as a "mess" and a "pig," and declared he would not own a share of the stock. But once the quiet period was over, Capek again began issuing extremely favorable reports on HealthSouth. *See* App. 6.

Repurchases Uses to Prop Up Stock Price

23. To help manipulate HealthSouth's stock price higher from September 1998 through March 31, 2000, Citi/Salomon and UBS and its bankers, according to Martin, analyzed and proposed that HealthSouth use nearly $300 million in corporate funds to repurchase 38 million shares of HealthSouth stock in the open market. As Capek wrote in May 1999 "as the acquisition pace slows, cash should be used to buy back stock."

24. Then in mid-May 2002, UBS helped Scrushy unload more than five million shares for proceeds of nearly $70 million – at the time UBS was internally worried about losing money on the transaction. Following this sale, UBS again urged HealthSouth to spend an additional $20 million to repurchase four million shares.

25. Shortly thereafter, Weston Smith told Owens in July 2002 that he had "very grave concerns about what we were doing" in light of the increased Sarbanes-Oxley ("SOX") penalties. Owens stated he would communicate Smith's concerns to Scrushy. Smith attempted to quit HealthSouth on August 5, 2002 and got an attorney. When Smith initially refused to sign the SOX certification, Owens and Scrushy decided to lower market expectations going forward blaming lower

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[2] "App." references refer to the Appendices to Joint Amended Complaint for Violations of the Federal Securities Laws filed on Jan. 8, 2004.

earnings on Transmittal 1753. Also Scrushy and Owens decided to attempt to split the Company into two parts to create a further diversion. Smith then agreed to sign the SOX certification as long as he got transferred to the surgery division. Scrushy wanted to spin off the Surgery Center and used UBS to attempt to do it. The weekend before HealthSouth was going to announce the phony bad news, Scrushy, McVay, Owens, Horton and McGahan had several discussions about this decision.

26. In August 2002, as speculation concerning defendant Scrushy's May 2002 stock sales increased, the UBS Defendants were involved in internal discussions at HealthSouth about what to tell the market concerning those sales. According to defendant Smith, McGahan was insistent that HealthSouth protect defendant Scrushy and provide information to the market to explain away the sales or Scrushy was "toast." McGahan informed defendant Smith and others that if Scrushy's stock sales were not adequately explained away there was a possibility that large institutional investors would demand new management be installed and with it would come the revelation of the Financial Fraud. According to Smith, McGahan kept repeating in words or substance "we have to work together; we have to save Richard; it's the only way." One of the ways Scrushy was helped was by lowering expectations claiming in an August 27, 2002 press release that Transmittal 1753 would severely impact HealthSouth's future revenues.

27. At the August 26, 2002 Board Meeting, McGahan, Rod O'Neill, Hugh O'Hare, Scott Wollard, John Wagner and J. Richard ("Rick") Leaman of UBS Warburg, led the board through a strategic alternative discussion on Project Crimson. *See* App. 5. 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 of the surgery centers (with or without IPO) or the sale of the diagnostic facilities. UBS then presented to the board a debt analysis and discussed how the current debt profile impacted the alternatives being considered. McGahan and the UBS

team presented a summary of the timeline of events to take place and led a discussion of the key separation decisions that HealthSouth would need to make.

28. Throughout the fall of 2002, defendants McVay and Owens worked closely with McGahan in attempting to find suitable purchasers for these business units. Owens specifically told McGahan that he needed to find a purchaser for the diagnostic division that would not want an audit. The books of this division were filled with fictitious capital assets. According to Owens, McGahan approached Tenet and other investors for the sale of these business units.

29. In the winter of 2002, Scrushy and Owens discussed a leveraged buyout ("LBO") of HealthSouth. UBS ran models and provided several different scenarios to get the LBO done. The largest problem for this transaction was the overstated cash. The LBO partner would expect to spend that money and HealthSouth could not do it. Scrushy told McVay and Owens to get creative with the cash situation in February 2003. Scrushy and Owens discussed the phony write-off from the prior quarter and discussed how to get out of the fraud.

Other Financing Needed to Continue Concealment of the Fraud

30. At the same time that the UBS Defendants were working furiously to sell HealthSouth's surgery and diagnostic divisions, McGahan was intimately involved in the negotiations to amend HealthSouth's $1.25 billion line of credit. HealthSouth desperately needed this credit line to provide it operating capital and permit the continued false perception of HealthSouth's financial prowess.

31. According to McVay, he and McGahan spoke "a dozen times" during November and December 2002 concerning the progress McVay was making with each investment bank. McVay informed McGahan during these conversations that the investment banks were asking a lot of questions about HealthSouth's need to amend its credit line in the face of carrying $400 million in cash on its balance sheet – the majority of which McVay informed McGahan did not exist.

According to McVay, McGahan provided a script for him to use in response to such inquiries. McGahan told McVay to tell the banks: (1) that HealthSouth was keeping the $400 million because the Company needed the flexibility; (2) HealthSouth was planning another debt offering; and (3) HealthSouth was planning another secondary stock offering and that if the banks wanted to be part of HealthSouth's future, they also needed to provide commercial financing. Despite McGahan's script, McVay was not able to get the full $1.25 billion that defendant Scrushy wanted, but was able to secure $700-$800 million using McGahan's script.

32. The UBS Defendants also took measures to control the flow of information during the due diligence on amendment of the credit line. According to McVay, McGahan told him he did not have complete control over the commercial bankers from UBS doing the HealthSouth due diligence in January 2003. McGahan told McVay in words or substance not to worry about it and that he could "backdoor" them with their boss on the commercial side and secure the financing.

33. The UBS Defendants' conduct described herein was undertaken for one purpose – to hide HealthSouth's true financial results and performance from the market. Without the UBS Defendants' active engagement in structuring transactions to hide the Financial Fraud and their intervention in the exchange of information with acquisition partners, underwriting partners and commercial lenders, the financial fraud could not have occurred or at the very least would have been discovered years earlier by investors.

SPEs and Off-Balance Sheet Accounting

34. McGahan and UBS were instrumental in developing HealthSouth's off-balance sheet financing including leases and SPEs. The Company later moved the leases and SPEs back on to the balance sheet as part of the restatement, increasing long term debt by $500 million in 2000 and 2001. Much of the reason the original accounting was improper was due to side agreements between

HealthSouth and UBS in which UBS required HealthSouth to guarantee loans by UBS to purportedly independent third parties.

35. A SPE financing that was in the process of being set up in 2002 for First Cambridge HCI Acquisition, LLC ("HCI") also involved a side agreement between HealthSouth and UBS to guarantee a loan by UBS to a purported independent third party – First Cambridge. This SPE had leased 13 facilities in 2001. This SPE on its own was used to understate HealthSouth's debt by $81 million.

36. McGahan was actually consulted on the off-balance sheet arrangements and details of supposedly independent third parties. In a correspondence to McGahan in March 2002 from Roderick O'Neill, it stated that O'Neill wanted to make sure there was "nothing wrong" on the HealthSouth REIT and then laid out that ownership of the REIT would be held by Scrushy's daughter, Owens, Horton, Smith and other insiders even though "no one has put any money into it." Thus, McGahan knew that the required independent ownership in the REIT was a sham.

Illegal Campaign Contributions Demonstrate the Illicit Connection Between UBS and HealthSouth

37. UBS was such an integral part of the scheme at HealthSouth that HealthSouth used UBS to funnel payments and bribes to politicians. For example, according to McGahan in late 1997, while he was still employed at Salomon Smith Barney ("SSB"), Scrushy, solicited him for a donation to "a cause in Alabama." McGahan recalled that about this time HealthSouth had acquired Horizon Health Care, along with it's long term care facilities and IHS desired to procure the former Horizon long term care facilities from HealthSouth. HealthSouth agreed to sell off the long term care assets to IHS on the condition that IHS, would cover the banker's fees for the transaction. According to McGahan, it was not long after this that he was called personally by Scrushy who was looking for a large donation to a political cause in Alabama. Scrushy asked McGahan to come up with the money for the contribution.

38. According to Martin, Scrushy told Martin to have UBS make a significant contribution to the lottery campaign. Scrushy advised Martin to remind UBS of the longstanding relationship between UBS and HealthSouth and that UBS owed the favor to HealthSouth.

39. After speaking with Scrushy, Martin telephonically contacted McGahan who was now at UBS. Martin advised McGahan of the need for the contribution and instructed McGahan to write a check from UBS. McGahan advised Martin that it was against UBS' policy to make political contributions. During a second phone call between Martin and McGahan, McGahan told Martin that he had an idea how UBS could help HealthSouth with the donation. According to Martin, McGahan offered to use fees owed to UBS for the banking services that UBS provided during a transaction between IHS and HealthSouth.

40. According to McGahan, he was called again by Scrushy who told him that he had good news and bad news. Scrushy stated that the good news was that HealthSouth had gotten IHS to be supportive of the donation request, but the bad news was that McGahan's fee due from IHS was going to be reduced in the amount of $267,000. Scrushy emphasized to McGahan that McGahan had received a large fee from HealthSouth at the closing of the Horizon acquisition deal and was also getting a fee on the sell-off of the long term assets from HealthSouth to IHS. McGahan reported the situation regarding the $267,000 fee reduction to his superiors Ben Lorello and Conrad Bringsford.

41. McGahan even called Owens at the end as illustrated by the following March 18, 2003 recorded exchange between Owens and McVay:

B. OWENS: I've tried to talk to RICHARD about the LBO. And I've ...

T. MCVAY: (UI) where is he going with it?

B. OWENS: I don't know.

T. MCVAY: I mean it doesn't make any sense.

B. OWENS: Yeah.

T. MCVAY: Hey, I'll be damn if I'm gonna get in a room with this guy and him ask me a direct question that I can't answer, I'm not gonna do it.

B. OWENS: I'm not either. Now, and, you and I both know, you and I can both say, I mean we've sat in meetings and told RICHARD, right, I mean, I'm just saying I got a very unusual call from BILL MCGAHAN this morning. That said to me, uh, he said, are you okay? I said, yeah, we're gonna be fine. Uh, he said, no, you personally, are you okay? I said, yeah, I'm fine BILL, why? He said, well, you know, I just, you know if RICHARD just, if RICHARD ends up just trying to blame you for all this mess and runs you off, don't worry. You know, you got plenty of friends.

T. MCVAY: That's pretty direct.

B. OWENS: And he said you've got a friend in me and he said, you know, you, you just, you just play a lot of golf for a little while and then we'll see what we do after that. And so, I mean, I'm scared, I mean, you know RICHARD's running around here, I mean, I don't know if he's gonna try to shift blame or something but, I mean you and I both know we've told him that there's you know, close to $400 million in the cash accounts that ain't there.

T. MCVAY: 399.

B. OWENS: $399 million, and, yesterday, you know, when he started talking to me about this LBO thing in my office, and I said, you know, RICHARD, I don't have any answers on the cash. And, and I said, I said, you know, and he stopped me. And he wouldn't let me say it. I mean he would not let me say the number in front of him.

Ex. No. 701-007T (Transcript of Ex. No. 701-007A-007B at 98-99).

E&Y's Role in the Scheme

42. E&Y, like UBS, was at the heart of the HealthSouth scheme to defraud its investors. As Alice Martin, the United States Attorney for the Northern District of Alabama, described the scheme: "This is not a mere 'accounting fraud,' but rather a business scheme to fraudulently boost HealthSouth's reported earnings." SAC ¶147. E&Y was a necessary partner in the scheme which, of course, could not have been accomplished without E&Y's active engagement in and furtherance of the scheme. As set forth in the SAC, at least as early as 1994, E&Y had actual knowledge of the fraud and provided a clean audit opinion despite knowing that the financials as certified by E&Y

overstated 1993 earnings by $27 million. Specifically, G. Marcus Neas, the E&Y audit partner in charge of the HealthSouth audit, in a disagreement with HealthSouth's Martin about whether to capitalize or expense $3 million in investment banking fees, informed Martin not to question him on the $3 million E&Y expense determination because Neas had already turned his head on the $27 million overstatement.

43. Nor was E&Y simply acting as HealthSouth auditors. E&Y was deeply involved in the core activities of the fraudulent scheme that furthered it not only by providing clean opinions year in and year out, but was providing opinions and updates for the Integrated Public Offerings, working on the acquisitions and turning a blind eye to the huge numbers being claimed by HealthSouth as to the impact of certain governmental programs or policies such as the BBA and Transmittal 1753.

44. Thus, aside from setting forth E&Y's actual knowledge of the fraud, red flags so numerous as to, in Emery Harris's words, amount to no audit at all, E&Y took an active role in the deception to gain millions in fees from the acquisitions, debt offerings and pristine audits – monies over and above their normal audit fees. Livesay noted that to him, E&Y was more interested in "papering" a file than trying to figure out any manipulations that might have been going on.

45. In addition to the allegations already set forth in the SAC, the pleading defendants would admit additional information about E&Y's active role in the scheme. And while a number of the pleading defendants would resort to one or more of the following: (1) misleading the auditors; (2) hiding information from the auditors; (3) providing phony or misleading documentation to the auditors and, (4) at least in Bill Owen's case, providing cover letters and/or excuses for open items at year-end, this was a necessary part of the scheme. E&Y reviewed the cover letters and made comments and changes to meet their documentation requirements. As to who reviewed and commented on these letters, Owens recalls that at least E&Y's Neas and Miller were involved.

Martin, for his part, would add that when he resigned from the CFO position in February 2000 before signing the management representation letter for year-end 1999, no one from E&Y ever contacted him about the 1999 numbers. If, despite E&Y's knowledge, HealthSouth's employees had stopped providing even minimal coverage, no one could have continued in their role in the scheme.

Year-End Open Issues Demonstrate E&Y's Participation in the Scheme

46. According to Owens, Smith, Livesay, and Harris, there were numerous open issues at the end of each year, often involving some of the same issues year in and year out. There were a number of items that were not resolved because HealthSouth simply could not provide information to support the accounting treatment applied. One way E&Y sought to resolve open issues was to tell HealthSouth to clean it up for next time, but HealthSouth often failed to do even this. Since Smith, Owens and others had come from E&Y, often they simply refused to answer the questions and E&Y still signed off on the financials. One blatant example was an outpatient inventory issue from the 2001 audit. Tens of millions of dollars were at issue for which no back-up could be provided, yet E&Y allowed HealthSouth to fix it over the following year. Smith believes there were enough red flags that in the early 1990's E&Y knew of the fraud or deliberately avoided knowing, and, as a result, E&Y did not follow up on open issues and allowed Healthsouth year after year to keep issues open that had to be resolved before E&Y could properly have signed off on a meaningful clean audit opinion. Harris believes that E&Y knew about the accounting fraud just by the way E&Y raised questions about open items. As Smith would elaborate, E&Y would actually provide excuses for the questioned item. For example, E&Y's Wayne "Snoop" Dunn would say "well if it's this way, then it would be OK" to which Smith would reply "yes it's that way" without providing any backup. Further, at different times E&Y would ask Harris to sign something or certify something and Harris would often just say "no" or remove his signature line and yet E&Y never questioned this practice.

Additional Red Flags

47. As set forth in the SAC, according to Owens, Smith, Livesay, and Harris, E&Y "missed" or deliberately ignored numerous red flags that screamed fraud. Of course, E&Y did not "miss" these red flags at all. Since E&Y knew about the fraud, E&Y knew that if it investigated the red flags E&Y would be forced to withdraw as HealthSouth's auditor and turn its back on millions of dollars in annual fees. Smith identified several ways in which E&Y worked to avoid getting information on HealthSouth's financials: (1) E&Y failed to reconcile cash receipts with revenue; (2) E&Y failed to review or insist upon detailed fixed asset schedules. Harris also confirmed this noting the most egregious examples were the discrepancy between what HealthSouth's outpatient physical therapy centers claimed to have in fixed assets and the actual assets at the facility; (3) E&Y failed to roll up HealthSouth's census and statistical information (information HealthSouth was required to do under government regulations) and compare it to the patient reporting information on the financials, *i.e.*, the patient days and outpatient numbers despite the ease of comparing this data; (4) E&Y failed to investigate the discrepancy between outpatient revenues (HealthSouth's were always higher) versus other companies. Of course, Smith believes E&Y was alerted, that the outpatient revenues were out of line and that Owens' explanations of workers' comp[3] and other things which could have been easily checked and never were, is simply another example of E&Y turning a blind eye; (5) Smith believes that the CFRA 1995 report, which was sent to E&Y, would have exposed several areas of the fraud if E&Y investigated the allegations in the report. E&Y had the CFRA 1995 report, was supposed to respond to the issues raised and, according to the

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[3] Owens explained that when questioned about how HealthSouth had a much higher revenue per patient charge from other hospitals, he used worker's comp patients as an excuse. The typical worker's comp charge is hundreds more than the regular out patient charge, but a review of the actual worker's comp statistics would have revealed HealthSouth did not have a disproportionate number of worker's comp patients.

Company's recent complaint against E&Y, to this day has not produced such a response. In short, E&Y's deliberate efforts to avoid facts regarding HealthSouth's financial reality, combined with E&Y's willingness to endorse false financial information, made its audit of HealthSouth no audit at all.

Acquisitions

48. According to Owens, Smith, and Livesay, E&Y was very involved in acquisitions, which were used to wash the fraud off HealthSouth's books. For example, according to Owens, the way that HealthSouth booked the Horizon transaction was "unbelievable" and the manipulation (internally at least) obvious. According to Livesay, who was directly involved in the manipulations in the Horizon transaction that were used to wash $414 million of fraud off HealthSouth's books, E&Y had to know of the fraud. According to Owens and Livesay, Horizon was acquired in October 1997 for about $1.6 billion in a stock-for-stock transaction accounted for as a purchase. The fair value of the Horizon assets were deemed to be around $1 billion leaving intangible asset (goodwill) accounts of approximately $600 million. Before year-end, HealthSouth sold the Horizon nursing home facilities to IHS for approximately $1.2 billion in cash. Livesay noted that there is an EITF (No. 87-11) that in a business combination where part of a company that is acquired is sold soon after the acquisition, there should be no gain recognized on the subsequent sale, but that the difference should be reallocated to goodwill so that any gain would reduce goodwill. By 1997, HealthSouth had more than $400 million in false earnings in a Suspense Account.[4] The gain on the IHS sale was used to eliminate the Suspense Account which had accumulated the false earnings that had been recorded by HealthSouth in prior quarters. Livesay changed the amounts of Horizon's inter-company accounts he had received from Horizon so that it looked like $400 million was an

[4] The Suspense Account was not put in any one asset category on the balance sheet. It was allocated among several assets.

inter-company account. He allocated this inter-company account among different assets to get rid of the suspense account on HealthSouth's books.

49. There had been a one page facsimile from Horizon that showed the real numbers before he changed them. Comparing this document to the numbers allocated to Horizon's various assets would have clearly shown the fraud. E&Y never requested any backup on the numbers Livesay provided and relied on his summary which was just an excel spreadsheet. If E&Y had done any real due diligence or requested the original Horizon numbers they would have immediately seen there was a problem. In addition, Horizon was a public company and E&Y could have and should have looked at Horizon's own financials. E&Y never did or if they did, they did not inquire about the discrepancy to anyone at HealthSouth to Livesay's knowledge. Owens points to the goodwill remaining on HealthSouth's books noting it was unfavorable in light of the sale, and yet E&Y said nothing. Owens considered this an "obvious" manipulation, but E&Y never challenged it. Furthermore, IHS was a public company which purchased the facilities and published an 8-K shortly after the acquisition showing how it allocated the assets which were dramatically different than the assets shown on Livesay's schedule given to E&Y. HealthSouth has admitted the accounting for this transaction was improper:

> In recording these two transactions, the Company overstated goodwill at December 31, 1997 by approximately $414 million. This, in effect, represented operating costs that should have been recognized in the consolidated statements of operations through that date.

Lease and SPE Accounting

50. E&Y also signed off on the improper accounting for 100 HealthSouth leases which permitted HealthSouth to keep hundreds of millions of dollars in debt off its books during 2000 and 2001. UBS was involved in lending money to third parties in some of these SPEs and leases and HealthSouth provided guarantees to UBS, which defeated HealthSouth's intended accounting for the transactions. Many of the leases involved HealthSouth's fleet of corporate jets. HealthSouth has

now admitted that "the Company previously accounted for approximately 100 leases dated prior to and throughout years ended December 31, 2001 and 2000 as operating leases, when it should have accounted for the leases as capital lease obligations." The Company also admitted it improperly accounted for sale-leaseback arrangements involving SPEs. The improper accounting caused long-term debt to be understated by $579 million in 2001 and by $468 million in 2000. Assets were also understated, but by less than half the amount debt was understated.

51. Due to the technical nature of these types of transactions, HealthSouth necessarily would have relied on its outside accountant (E&Y) to ensure it properly accounted for these SPEs and leases. Whether a lease is a capital lease or an operating lease is a very significant determination and constitutes a management assertion for which E&Y was required under then-existing auditing standards to gather sufficient competent evidential matter to verify. AU §326.06. One of the improper transactions involving an SPE was used to account for the construction of the corporate facilities in Birmingham. UBS was a lender in the transaction, with HealthSouth providing guarantees which undercut the intended accounting for the SPE. Given the importance of the structure of the SPE to the intended accounting, E&Y was required to devote significant attention to understanding the transaction. UBS was involved in both this transaction and with the purchase and sale of 13 real properties, both of which involved guarantees by HealthSouth which UBS and E&Y knew undercut the Company's accounting.

Integrated Public Offerings

52. E&Y, knowing of the fraud, not only issued clean audit opinions year in and year out, but provided the clean opinions for use in the illegitimate Integrated Public Offerings without which those offerings would not and could not have occurred. Thus, E&Y was an active participant in the continuing scheme to falsely portray HealthSouth to the SEC and the investing public in order to bring HealthSouth Notes to market. Including E&Y's false certifications in the Registration

Statements for the Integrated Public Offerings, as well as in the Prospectuses therefor, was intended to and did operate as a fraud on the regulatory process, for the Notes could not have been issued without these certifications. Without E&Y's false certifications, the Integrated Public Offerings would not have closed, the Notes would not have been issued at any price, and the Bondholder Class would not have experienced their substantial losses. The following Integrated Public Offerings within the current Class Period (after dismissal of the 1998 claims on statute of limitation grounds), contained E&Y's false audit opinions:

103/4% Senior Subordinated Notes (September 2000)	$350,000,000
81/2 Senior Notes (February 20001)	375,000,000
73/8% Senior Notes (September 2001)	250,000,000
83/8% Senior Notes (September 20001)	400,000,000
75/8% Senior Notes (May 2002)	1,000,000,000
Total	$2,375,000,000

53. These public distributions had their intended effect of bringing the Notes to market that, due to the defendants' fraudulent scheme were not entitled to be sold, and thereby obtaining the Bondholder Plaintiffs' money to fill the holes left by the Company's financial manipulations, paying taxes on fictitious income, providing much-needed cash, and paying down bank debt owed to UBS and others – all while avoiding extensive SEC scrutiny through the misuse of Rule 144A. These public distributions also had their intended effect of improving the market for HealthSouth securities. As McGahan (by now employed by UBS Warburg, LLC) explained at a March 9, 2001 HealthSouth Board meeting also attended by Lorello, the "successful bond offering and [UBS-organized] roadshow" had resulted in "positive momentum in [HealthSouth's] stock."

Florida Audits

54. According to Smith and Harris, Florida requires independent audits of hospitals. E&Y did the independent audit in those facilities and found all kinds of problems, but did not extrapolate these problems to the rest of the country. Smith could never understand this because the problems found at what had to be their best facilities, *i.e.*, ones that required an independent audit,

were 10 times better or had less problems than in other facilities across the country. And yet E&Y, Smith believes deliberately, never made the connection, or deliberately avoided a comparison.

55. Harris also said that a comparison of the reserves of the Florida facilities, which were much higher than reserves in facilities in other states is but another red flag E&Y deliberately ignored. E&Y had to have known about this difference and yet never questioned it. Also, Harris pointed out, if one took a look at the assets for the Florida facilities that had the independent audits, their fixed assets for those facilities would be, for example $13 million, and yet a facility in the same size range that was not to receive an independent audit in another state would have $20 million in assets. E&Y never questioned these differences.

Failure to Reconcile Cash – Amounts to No Audit at All

56. E&Y never followed up or reconciled the cash accounts. This simply amounts to no audit at all. The cash manipulations started in 1999. Initially the overstatements were reversed in the subsequent quarters, but later got too big and eventually grew to $370 million. Livesay said that E&Y accepted cash reconciliations for different time periods for different accounts making it possible for HealthSouth to move money between accounts and inflate the total amount of cash.

Inventory Outpatient Numbers and Fixed Assets

57. Another example was a year in which E&Y questioned the fixed assets and some changes that were made. Owens was able to convince them to let HealthSouth have some time asserting HealthSouth would fix it over the next year and E&Y looked the other way. Harris essentially says that E&Y's audit amounted to no audit at all. When an inventory problem exceeded $35 million one year came up, Lamphron, the partner in charge, said that he had to discuss it with Owens, the Board and Scrushy. That was the last Emery Harris ever heard about it. As far as he knows E&Y never pushed the issue.

Computer Systems

58. According to Smith, E&Y did a lot of acquisition work, made a lot of money and then at year-end, every year, year after year, accepted that HealthSouth would not give E&Y or allow E&Y access to their books and records for the year-end audit until very late in the process. Of course, E&Y never had total access and never access to the computer systems. While E&Y complained about it every year, E&Y did not make HealthSouth provide financial year-end information earlier or open up the computer systems – the money and the prestige from auditing such a large healthcare provider (a position from which other work could be obtained) as well as from the audits, acquisition work and pristine audits was simply too much for E&Y to turn from.

The following paragraphs replace paragraphs 320-330 and 366-416 of the SAC. Paragraphs 331-365 of the SAC describe HealthSouth's six Integrated Public Offerings.

THE INTEGRATED PUBLIC OFFERING SCHEME: THE UNDERWRITER DEFENDANTS' DECEPTIVE CONDUCT IN FURTHERANCE OF THEIR FRAUDULENT SCHEME AND THE FINANCIAL FRAUD

320A. Defendants Lorello and McGahan, during their employment with SSB prior to the spring of 1999 and with UBS thereafter, had a longstanding and substantial relationship with HealthSouth and many of the Senior Officer Defendants, including Scrushy, Owens and Martin. In their over sixteen-year relationship with HealthSouth, Lorello, McGahan and others at SSB and UBS were intimately involved in all aspects of the Company's operations and finances, became personal friends with several members of the HealthSouth "family," and attended many social functions at the invitation of HealthSouth family members. Indeed, McGahan and Martin were personal friends and spoke almost daily. Through the course of that relationship, Martin shared with McGahan much of what he knew about HealthSouth's Financial Fraud.

321A. Due to their extensive business and personal relationships with the management of HealthSouth, defendants Lorello and McGahan (and, thus, their employers SSB and UBS) gained actual knowledge of the Financial Fraud. Accordingly, these Defendants, who, as described herein,

had a demonstrated track record of doing anything they had to do–including providing the money Scrushy used to bribe an elected official–in order to keep the fraud going and the flow of fees coming, knew that HealthSouth could not withstand the scrutiny of the customary underwriter due diligence that a public offering of registered debt would require, nor could the Company hold up under the more rigorous scrutiny that the SEC affords registration statements filed in connection with typical public distributions. As a result, beginning in March 1998, Lorello and McGahan devised and executed a fraudulent financing scheme (the "Integrated Public Offering Scheme") that, over the following four years, would raise for HealthSouth (from the unsuspecting investing public) close to $3.4 billion and would line Lorello's, McGahan's and their employers' pockets with millions of dollars in fees, while hoping to evade the substantial and near-strict civil liabilities imposed under the Securities Act.

Defendants Lorello, McGahan and Capek, and Thus UBS, Had Direct Knowledge of the Financial Fraud

Lorello and McGahan Had Actual Knowledge of the Financial Fraud Through Their Work on HealthSouth's Acquisitions and Attempted Spin Offs

322A. McGahan first participated in HealthSouth's Financial Fraud in 1993, when he advised Martin how HealthSouth could "bake the earnings" through improper accounting for acquisitions. Specifically, McGahan's trick was to take a charge in an amount approximating 5% of the value of each acquisition, and then use that charge to increase future earnings. Together, HealthSouth and McGahan used an acquisition in 1993 to pad HealthSouth's earnings with "baked" revenues of $27 million. McGahan chose every succeeding acquisition for HealthSouth for the purpose of "baking" HealthSouth's earnings, and discussed with Martin "baking" earnings in connection with every acquisition HealthSouth did from 1993 onward.

323A. Lorello and McGahan gained further knowledge of the nature and extent of HealthSouth's fraud in 1995 when working on HealthSouth's acquisition of Surgical Care Affiliates (which closed in January 1996). Surgical Care's investment banker requested financial information

for certain individual facilities that, if provided, would not have lined up with HealthSouth's overall publicly disclosed financial information. Had HealthSouth disclosed the requested information, Surgical Care and its investment banker likely would have discovered the Financial Fraud. Martin, who was HealthSouth's CFO at the time, explained to McGahan in connection with Surgical Care's due diligence that HealthSouth could not provide the requested information. McGahan agreed to dissuade Surgical Care's investment banker from its request, and instead to persuade the investment banker to accept consolidated financial information instead of the facility-specific information requested. While HealthSouth's direction to McGahan to avoid customary due diligence requests should have set off alarm bells, McGahan willingly complied because he had participated in the Company "baking" of its earnings since 1993.

324A. From the Surgical Care Affiliates acquisition in 1995 through 1999 (when the focus of their deceptive conduct switched to bond investors instead of acquisition targets), McGahan, and his assistant, Rod O'Neill, participated in HealthSouth's deception of acquisition targets (for the purpose of "baking" earnings and covering the charges necessary to take the fraudulent financial manipulations off of HealthSouth's books), including in the following transactions:

Jan 1996	Surgical Care Affiliates	$1,400,000,000
Mar 1996	Advantage Health	345,000,000
Aug 1996	Professional Sports Care	70,000,000
Dec 1996	ReadiCare	70,000,000
Mar 1997	Health Images	270,000,000
Oct 1997	ASC Network	185,000,000
Oct 1997	Horizon/CMS Healthcare	1,650,000,000
Jun 1998	The Company Doctor	25,000,000
Jul 1998	33 Surgery Centers from HCA	500,000,000
Jul 1998	National Surgical Centers	590,000,000
Jul 1999	American Rehab. Services	50,000,000
Total		$5,155,000,000

Owens attended many meetings with McGahan and O'Neill in connection with every one of these stock-for-stock acquisitions. During those meetings, Owens either told, or witnessed others telling,

McGahan and/or O'Neill that HealthSouth could not ask any target company for certain due diligence information customarily exchanged in such deals because HealthSouth could not risk that the target company would seek the same due diligence information from HealthSouth. Defendants Martin and Weston Smith also participated in or witnessed certain of these conversations. These intentionally "excluded" due diligence matters were so integral to the businesses of HealthSouth and the target companies – including such fundamental aspects of the healthcare business as converting revenue into cash and depositing the cash in the bank – that their exclusion, out of expressed fear that HealthSouth would have to reciprocate, should have compelled the bankers to inquire further and challenge the deals. According to Owens, however, McGahan and O'Neill never expressed surprise at the repeated requests to conceal information, and instead always expressed their understanding that they and their colleagues understood the need to and would negotiate with the target companies such that the targets would not obtain from HealthSouth the incriminating information.

325A. In like manner, in connection with HealthSouth's aborted 2002 spin-off of the Company's diagnostic division, UBS, through McGahan and O'Neill, concealed HealthSouth's massive Financial Fraud. As defendant Owens explained, the Company's diagnostic division, which was being spun off at the same time as its surgical division, could not withstand the scrutiny of an audit by an acquiring company because a substantial component of the financial fraud—using fictitious capital assets to conceal bogus revenue—was recorded on the books of the capital-intensive diagnostic division. As a result, Owens told McGahan in 2002 that he had to find a buyer for the diagnostic division that would not require an audit. McGahan responded without inquiry to this highly unusual request, saying to Owens, in words or substance, "I understand and will follow your instructions."

326A. Owens also explained that HealthSouth always took the unusual step of refusing to provide acquisition targets with any of HealthSouth's monthly financial statements even though monthly financial statements were readily available. According to Owens, HealthSouth refused to provide monthly financial statements because the first two months of each quarter generally disclosed poor operating results, while the third month always included the fraudulent entries generated to achieve a quarter that met or beat Wall Street expectations. Thus, as Owens put it, the fraud would "stick out like a sore thumb" to anyone who looked at those monthly financial statements. The Company's refusal to provide acquisition targets with HealthSouth's available monthly financial statements was highly suspect, and should have caused the experienced bankers to inquire further. Nevertheless, neither Lorello, McGahan, O'Neill, nor anyone at SSB or UBS (nor any other Underwriter Defendant) ever challenged HealthSouth's curious refusal to provide key financial information that is routinely created by Fortune 500 companies and customarily provided in due diligence.

McGahan Had Direct and Actual Knowledge of the Financial Fraud

327A. Martin, a former CFO of HealthSouth, specifically disclosed the size and scope of the rapidly growing Financial Fraud to McGahan in early 1999. Martin recounted that, by the summer of 1998, HealthSouth's actual and reported results were so far apart that HealthSouth was about to "hit the wall." The "family" was running out of ways to conduct the fraud. Martin discussed with McGahan the Company's need to identify a large acquisition target. Again, in January of 1999, Martin advised McGahan that the Company was not even close to making its earnings, and that it needed a very large acquisition to provide cover for its low earnings. McGahan identified HCR-Manor Care as a potential acquisition target to cover up the missed earnings. As alleged in the Second Amended Complaint, however, Martin was concerned that due diligence by HCR-Manor Care would uncover the fraud. Additionally, Scrushy had negotiated for the HCR-Manor Care CEO

to become CEO of the combined companies, providing an "exit strategy" for Scrushy. Martin also was concerned that the new CEO would quickly uncover the fraud. According to Martin, he and McGahan took a trip to visit Scrushy at his mansion on Lake Martin in June or July 1999 to discuss, among other things, the HCR-Manor care acquisition. While en route to that meeting, Martin told McGahan that HealthSouth had been systematically falsifying its financial statements, explained the scope and size of the fraud, and stated that the Company was on track to miss earnings estimates by $280 to $300 million. Martin then asked McGahan to help him persuade Scrushy not to proceed with the merger for fear the fraud might be revealed, and McGahan promptly agreed to do so. According to Martin, none of the information he conveyed to McGahan during the trip to Lake Martin appeared to surprise McGahan, nor should it have, since McGahan had been working with Martin and HealthSouth to identify acquisition targets since 1993 for the purpose of "baking" HealthSouth's earnings.

328A. According to Martin, from 1999 through at least the fall of 2002, he and McGahan had regular conversations regarding the potential civil and criminal ramifications of the ongoing fraud, including specific discussions regarding the statute of limitations applicable to potential civil claims, and the likelihood of criminal prosecution and the penalties likely to flow from such prosecution, including the possibility that McGahan and senior HealthSouth executives could go to prison. According to Martin, when news reports in the fall of 2002 began to make him more uncomfortable that the fraud might be exposed, he spoke with McGahan, who said, in words or substance, "someone is going to jail." Aware that UBS had, among other things, orchestrated the sale of billions of dollars of HealthSouth Notes despite McGahan's personal knowledge of and participation in the fraud, Martin said in substance, "If I'm going, you are going too." McGahan did not protest Martin's observation.

329A. In sworn testimony before the Energy and Commerce Committee of the United States House of Representatives in November 2003 in connection with the Congressional investigation into the HealthSouth accounting scandal, McGahan admitted that UBS knew that HealthSouth's May 2002 Registration Statement was materially false and misleading before it was declared effective, but claimed that UBS bore no responsibility for the content of the May 2002 Registration Statement because UBS (supposedly) had no role in the registration process.[5] That exchange is as follows:

Rep. Greenwood:	There was a billion dollar bond deal, a bond offering, in May of 2002. Are you familiar with that?
McGahan:	Yes sir.
Rep. Greenwood:	Okay. It's my understanding that HealthSouth initially filed with the SEC to register the bonds on June 28, and amended that filing on August 22. We've 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, if HealthSouth were to learn about a material negative impact on its finances, what should happen to the pending bond registration?
McGahan:	My understanding – although I'm not an attorney, my understanding is it should be updated.
Rep. Greenwood:	Updated or –

[5] As alleged in more detail below, McGahan's testimony that UBS had no role in the registration process was false. On the contrary, Owens has confirmed that UBS drafted or substantially participated in the drafting of the Registration Statements and throughout the exchange process. Under the Securities Act, therefore, UBS was responsible for the false statements and omissions in the Registration Statements. *See* 15 U.S.C. §77b(a)(11) (defining "underwriter" as any person "who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or ***participates or has a direct or indirect participation*** in any such undertaking, or participates or has a participation in ***the direct or indirect underwriting*** of any such undertaking."); 15 U.S.C. §77k(a)(5) (underwriters among those who may be sued for false and misleading registration statements).

McGahan: In terms of the disclosure. If they've learned new information, my understanding is –

Rep. Greenwood: Give that information to the ... and put it in with the SEC?

Rep. Greenwood: So they need to give that information to the –

McGahan: And put it in –

McGahan: Into the SEC. That's my understanding, although we weren't advising HealthSouth on that. That's for their counsel and internal counsel.

Rep. Greenwood: So that's not UBS' responsibility?

McGahan: Absolutely. We have nothing to do with it.

Rep. Greenwood: That's the company's responsibility?

McGahan: Yes, sir.

* * *

Rep. Greenwood: Now, are you aware that yesterday's indictment of Mr. Scrushy includes, "false statements counts directed to, among other things, the June and the August SEC registration filings for the quote, bond issue?

McGahan: I wasn't aware of that, but that's –

Rep. Greenwood: Okay. If you look at tabs 20 and 21 in your book, they indicate that in August of 2002 – by the looks of the tab 20 e-mail, at least as early as August 13, HealthSouth was preparing to issue a press release regarding the impact of Transmittal 1753. The tab 21 e-mail 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?

McGahan: Yes, sir.

Rep. Greenwood: Okay. HealthSouth disclosed this financial hit to UBS on the 23rd and issued the press release on the 27th. And in between those dates, on August 26, the registration became effective. So as I see it, UBS and HealthSouth had the opportunity to notify the SEC to postpone registration of these bonds, isn't that right?

McGahan: No sir. I was – we were – I personally was completely unaware of the registration process going on, and that's not anything that we have anything to do with at all. They work with outside counsel and attorneys on their public filings, but not with the investment bankers.

Rep. Greenwood: Did UBS inform their inside counsel that this was going on?

McGahan: UBS did inform the proper folks in terms of inside counsel what we were working on, but we had no knowledge of the SEC filings or we weren't reviewing them. Whatever HealthSouth was doing in terms of the bond indenture, we just didn't have anything to do with.

Rep. Greenwood: So on August 23 UBS knew that there was going to be a $175 million impact on the company, right? Both HealthSouth and UBS knew that?

McGahan: I believe so, yes.

Rep. Greenwood: And you felt no obligation to disclose that information to the SEC?

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. In terms of their public disclosure, we're 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.

Rep. Greenwood: Why would they have sent those e-mails to you if you were not advising them on their disclosures?

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.

Rep. Greenwood: And UBS has no role whatsoever in the registration process for these bonds?

McGahan: We don't.

Rep. Greenwood: And as far as you know, HealthSouth never informed the SEC on August 23rd of this impact?

McGahan: I just don't know. I have no idea.

McGahan thus admitted that, during the summer of 2002, UBS knew that the May 2002 Offering Memorandum, as well as the not-yet-effective May 2002 Registration Statement, was materially false and misleading. Nevertheless, UBS never notified the SEC nor caused the Company to notify the SEC concerning the not-yet-effective May 2002 Registration Statement that, according to Owens, UBS had prepared or directly and substantially participated in preparing.

330A. McGahan's knowledge about HealthSouth's Financial Fraud also was readily apparent to Owens and Martin because of the way McGahan purposefully and all too easily "derailed" even the minimal "due diligence" investigations the other Underwriter Defendants attempted to conduct in connection with selling the Notes. According to Owens and Martin, "due diligence" relating to the Integrated Public Offerings typically consisted of just one session for each Integrated Public Offering, conducted in person for the earlier Integrated Public Offerings and then via telephone conference for the later ones. Those meetings were attended by McGahan, who always was in the same room as either Martin or Owens, and representatives from each of the other Underwriter Defendants that were participating in the particular Integrated Public Offering. At each such meeting or conference call, representatives of the other Underwriter Defendants attempted to ask questions of Martin and/or Owens that, if answered, might have revealed at least some material portion of the Financial Fraud. When that happened, however, Martin, and later, Owens, would signal McGahan, who would then take whatever measures were necessary to "derail" the question and sidestep the inquiry.

331A. None of the Underwriter Defendants pursued the information in the face of McGahan's obstruction; however, even without the most basic information, and despite that unusual hindrance, all of them sold Notes to their Qualified Institutional Buyers' ("QIB") clients and the investing public. Had the other Underwriter Defendants fulfilled their responsibilities either to obtain answers to their questions or to refuse to participate in the Integrated Public Offerings, the

Financial Fraud would have been revealed and/or the Notes would never have been sold at any price and members of the Bondholder Class would not have suffered the many hundreds of millions of dollars of damages. The Underwriter Defendants' relegation of their role to one conference call at which their questions were consistently and purposefully thwarted by McGahan constituted a complete and at least severely reckless abdication of their responsibilities to the investing public.

Lorello Had Actual Knowledge of the Financial Fraud

332A. Lorello, too, was aware of the Financial Fraud. In addition to being kept fully apprised of all HealthSouth related developments by McGahan, Lorello affirmatively took steps to assure that the "family members" continued to report false earnings. Among the facts evidencing Lorello's knowledge of, and involvement in, the wrongdoing were those that came to light in connection with the sentencing proceeding involving Defendant Emery Harris, who, together with his subordinates, was responsible for implementing the false accounting entries at HealthSouth. At his sentencing proceeding in November 2003, Harris recounted listening to a chilling voicemail message from "Ben at U[B]S Warburg" (understood to be Lorello) to Martin, the then-CFO of the Company, warning Martin that "it was important for him to lay down for the family," *i.e.*, to make sure that HealthSouth continued to report earnings matching Wall Street expectations, or else he (and presumably others) could "get whacked."

333A. According to Harris, Martin purposefully played the voicemail message for Harris, Morgan, Livesay and Owens, telling them in words or substance, that "this is why I ask you to do the things I ask you to do" to promulgate the Financial Fraud. This voicemail, which Lorello left for Martin at the time that the Company's accounting staff was closing HealthSouth's books for a quarter, shows that Lorello knew that the Company's results did not meet Wall Street's expectations, and that the "family" needed to "make things happen" so that HealthSouth could report the expected results. Accordingly, even if one presumes that McGahan somehow failed to share with Lorello

what had been confirmed for him by Martin by June or July 1999, this voicemail confirms that Lorello knew by no later than late 1999, and, quite likely, even before that, that the Company was committing financial fraud in order to meet Wall Street's expectations. With UBS as its lead investment bank, HealthSouth issued to the public $2,375,000,000 in debt after Lorello's voicemail message to Martin.

334A. Lorello also participated in at least some of the "due diligence" conference calls at which, according to Owens, Lorello and/or McGahan, upon receiving Owens' signal, derailed the participating underwriters' inquiries that might have revealed aspects of the fraud.

Capek's Actual Knowledge of the Financial Fraud

335A. Capek also had actual knowledge of HealthSouth's Financial Fraud. According to Martin, after Lorello, McGahan and Geoffrey Harris (SSB's HealthSouth analyst) left SSB in 1999 to join UBS, Scrushy wanted Harris replaced as the analyst providing coverage for HealthSouth because Harris had disclosed in one of his analyst reports information that Scrushy wanted to remain concealed. Martin proposed that UBS hire Will Hicks, who was then an analyst for Cowen & Co. At Martin's urging, UBS did offer the position to Hicks, but even though he was offered a very generous salary, Hicks turned down the job because McGahan had told him that he (McGahan), rather than Hicks, would decide what Hicks' reports would say. In fact, McGahan told Hicks that his first two UBS reports on HealthSouth would be positive, with a "Strong Buy" recommendation. After Hicks refused the position due to McGahan's improper influence over the analyst reports, Scrushy directed UBS to hire Capek, who was then issuing positive reports on HealthSouth as an analyst at Credit Suisse First Boston. UBS hired Capek in May 1999. Ignoring the so-called "wall" intended to separate investment banking activities from securities analyst activities at investment banking firms, Lorello, McGahan and Capek worked together and with Scrushy to promote and solicit purchases of HealthSouth's stock and debt.

336A. Once on board, Capek:

- Immediately initiated UBS's coverage of HealthSouth with two "Strong Buy" recommendations in May and June of 1999.

- Maintained that recommendation notwithstanding his own privately held contrary views.

- Just three months after initiating coverage with a "Strong Buy" recommendation, Capek, in an August 19, 1999 e-mail to Susan Zeeb, a favored client, stated with respect to HealthSouth that "***I'd love to publish on this pig***, then I wouldn't be spending so much time in Birmingham in July/August." Capek went on to explain: "***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***" (emphasis added).

- In another e-mail to Susan Zeeb, this one dated September 10, 1999, Capek stated about HealthSouth, "***what a mess. I wouldn't own a share.*** We need to speak on this one" (emphasis added). Capek did not share these views with the investing public, to whom he issued and continued to issue glowing "Strong Buy" recommendations.

- Maintained his "Strong Buy" recommendation until August 27, 2002, and made false positive statements about the Company's business, financial and operating conditions detailed in Appendix 6 notwithstanding that: 1) as described below, he knew that HealthSouth was improperly capitalizing expenses; 2) UBS knew all about the financial fraud; and 3) as described below, UBS had internally concluded that HealthSouth presented a "High" credit and business risk, and, therefore, that UBS would not lend the Company money without undisclosed conditions.

- Only dropped his rating to "Buy" on August 27, 2002, when the SEC's investigation into Scrushy's insider stock sales became public.

- Was the last analyst to drop his rating on HealthSouth once the SEC investigation became public.

See also Appendix 6.

337A. In or about the summer of 2001, Capek acknowledged to Martin that he knew that HealthSouth had been improperly capitalizing expenses as part of the Company's scheme to inflate its earnings. According to Martin, Capek told him, in words or substance, "The Company is going to have to stop capitalizing expenses."

338A. The facts set forth above demonstrate that Lorello and McGahan knew about HealthSouth's vast accounting fraud and, as a result, knew that the Offering Memoranda that their

employer was distributing to QIBs in order to sell the Notes were materially false and misleading. For the same reasons, those Defendants (and therefore UBS) also knew that the Registration Statements and Prospectuses (which, according to Owens, UBS prepared or substantially participated in preparing) were materially false and misleading. Nevertheless, these Defendants did not cause HealthSouth to correct the Registration Statements or Prospectuses or inform the SEC about the material misstatements in those filed and distributed documents. Rather, as exemplified in a July 3, 2002 e-mail, UBS actually took steps to conceal from the market its conclusion, as set forth in more detail below, that HealthSouth was a poor business and credit risk. That UBS e-mail directed UBS to sell-down its position in HealthSouth debt in "30 days or less," stating that "less than 30 days is better without spooking the market," and that UBS should "support[] our underwritings, to a point."

339A. These facts also demonstrate that UBS, Lorello, McGahan and Capek had direct knowledge of the fraudulent nature of HealthSouth's accounting at the very same time that UBS was issuing glowing analyst research reports "strongly" recommending that investors buy HealthSouth securities. As described in more detail in Appendix 6, in the analyst reports, UBS and Capek falsely extolled the purported strength of HealthSouth's business, its minimal exposure to Medicare reimbursement problems, the quality and integrity of its management team and its strong earnings and financial condition, and also falsely downplayed the significance of material adverse events occurring at HealthSouth, such as UBS's August 27, 2002 analyst report, in which Capek only dropped his rating to "Buy" after the SEC's investigation into Scrushy's insider stock sales became public. Thus, the UBS analyst reports issued during the Class Period were materially false and misleading.

The Importance to Lorello and McGahan of Keeping HealthSouth's Business Going and the Lengths to Which They Would Go to Keep It

340A. Lorello, McGahan and others at UBS were eager to keep HealthSouth fees coming, even if (as they knew) it meant they had to keep the fraud going. In fact, by 1999 they had become so intertwined with the fraud that they agreed to Scrushy's demand that UBS provide the $250,000 that he used to bribe Alabama's Governor. According to testimony in the recent criminal trial of Scrushy in Montgomery, Alabama, Martin and Scrushy contacted McGahan in late June or early July 1999 and demanded that UBS contribute $250,000 to $300,000 to the Alabama Education Lottery Foundation, which Alabama's then-Governor Don Siegelman had made a centerpiece of his campaign and administration. Lorello and McGahan had only recently moved from SSB to UBS, and to justify his multimillion dollar income, McGahan felt pressured to produce for UBS the multimillion dollar revenues that he had produced for SSB. Maintaining the flow of fees from HealthSouth (which in some years reached $10,000,000 per year) was central to achieving that target.

341A. The demand to McGahan came shortly after HealthSouth had successfully insisted that Geoffrey Harris be removed by UBS as the analyst responsible for reporting on HealthSouth because Scrushy was displeased with Harris. It also came days after the trip to Lake Martin during which Martin and McGahan had discussed in detail the extent of HealthSouth's Financial Fraud.

342A. Eager to please Scrushy, McGahan arranged for UBS to be the source of the funds for the bribe. To conceal UBS as the source of the funds, however, McGahan obtained the agreement of a UBS client with ties to Scrushy – IHS – to write a check for $250,000 to the Alabama Education Lottery Foundation, and to provide the check to Scrushy so that he could hand deliver it to the Governor. In turn, McGahan and Lorello, on behalf of UBS, agreed to reduce by $267,000 the balance due on a fee that I owed UBS for investment banking services. Thus, the $250,000 Scrushy used to bribe the Governor of Alabama actually cost UBS $267,000. On June 29, 2006, Scrushy –

with McGahan testifying to the facts described above – was convicted of bribing Governor Siegelman with the $250,000 funded by UBS.

343A. In order to obtain additional lucrative underwriting business, UBS also promised to provide the Company with commercial financing, even though (as described in more detail below) UBS secretly harbored significant concerns about HealthSouth's business and credit risks. According to Owens, when HealthSouth was trying to raise both commercial and public financing in the spring and early summer of 2000, he and McVay told McGahan that UBS would have to provide HealthSouth with substantial commercial financing if UBS wanted to get the largest allocation of the underwriting component. Owens and McVay told McGahan in words or substance that, if UBS did not "step up on the commercial side" of the financing, HealthSouth would substantially reduce UBS's allocation of the underwriting and offer the underwriting to commercial banks in return for commercial financing. Lorello and McGahan responded by meeting with Scrushy without notifying Owens or McVay and by promising to provide all of the commercial financing the Company needed. Scrushy then compelled Owens and McVay to use UBS "because they were giving us all that money." However, driven by significant concerns about HealthSouth's business and credit, UBS did not want to risk its own capital with HealthSouth and syndicated substantially all of this commercial financing to other banks while retaining the lucrative role as HealthSouth's lead underwriter.

344A. More specifically, with respect to the financing identified above, UBS documents reveal that, at the same time that UBS and other Underwriter Defendants were selling HealthSouth securities to the investing public, UBS had determined, but did not disclose to investors, that HealthSouth was a poor credit and business risk and that UBS would mitigate its exposure to that risk by providing commercial financing only in exchange for continued investment banking fees from HealthSouth. For example, a June 21, 2000 UBS Global Credit Recommendation, which was prepared in connection with UBS's $687 million participation in a HealthSouth credit facility, stated

that UBS considered HealthSouth's industry and business risks to be "High," and that the facility was "borderline credit and recommends a C-6 rating." As a result, the recommendation continued, "[i]f UBS' exposure cannot be brought down to USD 100 million or lower . . . UBS should not proceed with this transaction." The recommendation included such "Negatives" concerning HealthSouth as:

- "a large part of the receivables are non-performing (25% in '99, up from 14% in '98)"; and
- "lower than expected growth in patient volume and continued payor issues"; and
- "Managed care payors are authorizing fewer visits to HealthSouth locations than in the past."

In a July 11, 2000 Credit Proposal Memorandum, which described UBS's continued consideration for the approval of that $687 million credit facility for HealthSouth, HealthSouth again was given a Credit Risk Rating of "C-6," which was one of the lowest ranges ascribed by UBS, and explained that UBS should reduce its "Own Take" due to "the considerable business and financial risk which HealthSouth is facing," and that the Company had "limited distribution capacity."

344A. The minutes of a May 8, 2002 Leveraged Finance Commitments Committee Meeting, which was held to consider approval of a $120 million commitment to a five-year HealthSouth $1.45 billion senior unsecured revolving credit facility, disclosed that UBS's Credit Risk Committee approved the transaction, but only a "final hold of $50 million (to be achieved within a 6-month period), and assigned an internal credit rating of C-6." These minutes also reveal that this transaction was approved in contemplation of UBS's participation as "bookrunning manager (on the left)," which indicates the lead position, on what was then expected to be a $500 million senior unsecured notes offering. That notes offering ultimately became the $1,000,000,000 May 2002 Integrated Public Offering. The minutes noted that UBS "expects to earn approximately $900,000 in bank fees and $1.2 million in bond fees for $2.1 million in total fees." None of UBS's internal

concerns relating to HealthSouth's business and credit risks were disclosed to the investors in the May 2002 Integrated Public Offering.

345A. UBS's internal concerns about HealthSouth's business and credit risk persisted in 2003. However, Lorello's and McGahan's incentive to maintain their profitable relationship with HealthSouth, Scrushy, Owens and others at the Company was so intense that, even as HealthSouth and Scrushy faced a variety of adverse situations, including SEC and FBI investigations and a DOJ civil lawsuit, Lorello and McGahan pressed UBS to continue to provide financing to HealthSouth. According to minutes of several meetings of UBS's Global Syndicated Finance Commitment Committee, its Leveraged Finance Commitments Committee, and its Credit Risk Committee, all of which were held in connection with HealthSouth's attempt in early 2003 to obtain a $22 million short-term credit facility for Source Medical Solutions Inc., another HealthSouth venture, and, at the same time, an amendment to the Company's $1.25 billion credit facility, there was strong opposition to UBS approving Corporate Finance's request. The minutes state:

- Global Syndicated Finance Commitment Committee (February 26, 2003): David Bawden, the Deputy Credit Commitment Officer (who had Credit Risk Committee authority) stated that he was "concerned about dealing with these entities ... I wouldn't trust Scrushy, Rod [O'Neill from Corporate Finance], further than we can throw him. ***I don't think this company [HealthSouth] has been transparent with us in the past***" (emphasis added). Bawden continued that UBS "should only be doing it [accommodating HealthSouth] for companies with decent reputations, and this company's tarnished its reputation in just about every which way over the last year."

- Leveraged Finance Commitments Committee (March 6, 2003): The Credit Risk Committee "believes that [HealthSouth]'s actions over the last two weeks have damaged the company's credibility with UBSW." The Leveraged Finance Commitments Committee was "[s]keptical that the Company will achieve projected 2003 full year EBITDA of $1bn+."

The latter committee instructed UBS's Corporate Finance department to, among other things:

- "Obtain an explanation from the Company as to why [UBS was] advised to use August 2002 guidance for Q4 [2002] results two weeks before actual results were reported, showing a significant reduction in EBITDA from the August guidance."

- "Advise the Company not to issue a Borrowing Notice."

- "Obtain confirmation from the Company that the [HealthSouth] contracts with Source Medical exist and that the backlog as previously reported has not changed."

346A. The following series of e-mails concerning these two transactions demonstrate Lorello's and McGahan's desperation to convince UBS to close ranks with HealthSouth in the face of strong and well-founded opposition, as well as the closeness of the relationship between Lorello and McGahan, on the one hand, and HealthSouth and Scrushy, on the other:

- March 6, 2003, at 3:50 p.m. – McGahan to O'Neill and Michael Leder (both in McGahan's Corporate Finance Group):

  I just got my ass whipped by Scrushy 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) it MUST NOT leak into the 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.

- March 6, 2003, at 4:14 p.m. – McGahan to O'Neill and Leder:

  Mike and Rod, you two are responsible for getting the hrc [HealthSouth] bank amendment approved. My entire career is on the line. Work quickly and carefully. Are you on top of this??!!???

- March 6, 2003, at 5:05 p.m. – Scrushy to McGahan ("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 [dollars] 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 come back strong and kick butt again. Thanks for the help over the years. We had some good times. Richard

- March 6, 2003, at 5:13 p.m. – McGahan to Scrushy:

> 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

- March 6, 2003, at 5:14 p.m. – McGahan to Lorello, O'Neill and Leder:

  > Just to fill you in on what I just got. Please get this done asap!!!

- March 6, 2003, at 5:18 p.m. – McGahan to Lorello (forwarding McGahan's 5:13 pm response to Scrushy):

  > I hate my job. I resign. Go jump off a bridge.

- March 6, 2003, at 5:26 p.m. – to Chris Ryan (UBS Credit Risk Committee, forwarding Scrushy's 5:05 p.m. e-mail and McGahan's 5:13 pm response):

  > 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 [million] loan. What else can I do internally not to permanently blow up this relationship by not getting there asap on the amendment? Bill

- March 7, 2003, at 6:23 a.m. – Ryan to McGahan:

  > Internally, not much. Externally, it depends. If the timeline exonerates HRC [HealthSouth], 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

347A. Lorello and McGahan's intent to maintain their lucrative relationship with HealthSouth also extended to personal favors for several of the Senior Officer Defendants, including Scrushy, as well as to UBS's financing of several of HealthSouth's questionable "off-balance sheet" special purpose ventures. For example:

(a) The minutes of a May 6, 2002 UBS Equity Capital Markets Committee meeting, during which UBS discussed selling for Scrushy a block of 5.2 million shares of HealthSouth common stock, referred to HealthSouth as "one of our best [h]ealthcare clients," and noted that, "[i]n the last 9 years, we have done 60 transactions with them." One week later, UBS approved that transaction over concern about risk that UBS may lose money on the trade. After the

transaction was completed and the sale came under public scrutiny, McGahan, according to Smith, insisted that HealthSouth protect Scrushy and provide information to the market to explain Scrushy's sales or Scrushy was "toast." McGahan informed defendant Smith and others that if Scrushy's stock sales were not adequately explained away, there was a possibility that large institutional investors would demand that new management be installed and with it would come the revelation of the Financial Fraud. According to Smith, McGahan kept repeating in words or substance ***"we have to work together; we have to save Richard; it's the only way***."

(b) UBS invested with HealthSouth executives in companies that did hundreds of millions of dollars of business with HealthSouth. For example, a newly created UBS-controlled entity was an investor along with Scrushy and other HealthSouth executives and directors in a company called MedCenter Direct.com ("MCD") formed by these investors with the help of HealthSouth. In late 1999, HealthSouth initially invested $2.2 million in MCD. The minutes of a March 28, 2001 meeting of UBS's Leveraged Finance Commitment Committee disclose that UBS approved a $15 million 7-month term loan facility to MCD. UBS agreed to provide the financing only after HealthSouth guaranteed 100% of the loan, and agreed to limit to $345 million its access to the Company's then-existing $400 million credit facility from UBS. Those minutes explain the substantial nature of the relationship between UBS – particularly Lorello and McGahan, the Co-Chairs of UBS's healthcare corporate finance team – and HealthSouth:

> This financing is purely a relationship concession to HealthSouth, with the full sponsorship of UBSW's HealthCare CFD [Corporate Finance] team. HealthSouth is a key relationship for CFD and LFG [Leveraged Finance Group] 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.

By 2001, HealthSouth was MCD's major customer, buying over $100 million a year in medical supplies from this insider-controlled entity – with over 50% of HealthSouth's facilities purchasing supplies from this company.

(c) In December 2001, UBS agreed to act as lead arranger on a 12-month $82.2 million senior secured term loan to HCI, a special purpose entity created to purchase HealthSouth properties. HealthSouth guaranteed 100% of that debt, and entered into a "keepwell" agreement, whereby HealthSouth agreed to stand behind any property that went into default. UBS agreed to enter into this financing transaction with HealthSouth only as a quid pro quo for being named the Sole Bookrunning Manager of HCI's anticipated 2002 initial public offering, and to obtain a "very senior role" in HealthSouth's refinancing of its $1.75 billion Credit Facility, which was to be coupled in the first three months of 2002 with a corporate finance transaction. Neither the financing transaction, nor the bases for it, were publicly disclosed to investors.

349A. UBS also did other personal favors for Scrushy, including setting up First Cambridge REIT for Scrushy's daughter and other HealthSouth executives, including Owens, McVay, Horton, J. Brown and Richard Davis.

Through the Integrated Public Offering Scheme, UBS, Lorello and McGahan Engaged in Deceptive Conduct That Had the Principal Purpose and Effect of Creating False Appearances of Fact and Evading the Registration Requirements of the Securities Act

The Integrated Public Offering Scheme

350A. Beginning in the late 1980s, and continuing through the mid-1990s, HealthSouth, with the substantial assistance of Individual Underwriter Defendants Lorello and McGahan, and, among other Underwriter Defendants, SSB, raised for HealthSouth capital from the investing public through a series of registered equity and debt offerings. Specifically, since the Company's $13,000,000 initial public offering in September 1986, HealthSouth raised capital through its public offering of $50,000,000 of 7¾% convertible subordinated debentures in May 1989; its $57,000,000 secondary public offering in June 1990; its $74,000,000 secondary public offering in May 1994; its public offering of $115,000,000 of 5% convertible subordinated debentures, and of $250,000,000 of 9½% senior subordinated notes, both in March 1994; and its $350,000,000 secondary public offering in September 1995. As a seasoned investment-grade company, HealthSouth employed the

customary structure of registering its securities with the SEC using the prescribed form of registration statement and, once that registration statement was declared effective, selling the securities to underwriters, which, in turn, sold the securities to the investing public. One of the noteworthy consequences of raising capital in this manner was that those underwriters would be subject to potential liability under the Securities Act should it come to light that the offering materials contained a material misstatement or omission.

351A. This exposure came to pose a problem for Lorello and McGahan because, as detailed above, they knew that HealthSouth was cooking the books. Indeed, McGahan had participated in "baking" HealthSouth's books through improper acquisition accounting since 1993, and McGahan had concealed the true financial condition of HealthSouth from acquisition targets, investors and the SEC since at least 1995. As described above, by1998 the size and the scope of HealthSouth's fraud had escalated to hundreds of millions of dollars. As a result, it was becoming more and more likely that SEC's scrutiny of HealthSouth's registration statements would lead to discovery of the fraud. Accordingly, Lorello and McGahan concocted a financing plan for HealthSouth that would enable them to continue to pocket millions in banking fees from their biggest client, yet also minimize – and hopefully eliminate – the Underwriter Defendants' exposure should the fraud come to light.

352A. Notwithstanding the foregoing track record of ready access to the public capital markets, HealthSouth abruptly changed course in 1998. At the urging of Lorello and McGahan, HealthSouth abandoned its decade-plus history of raising capital through single-step offerings, and instead adopted a more cumbersome and expensive two-step procedure to sell Notes to investors. Specifically, from March 1998 onward HealthSouth split its six public debt offerings (the "Integrated Public Offerings") into "private" and "public" components in purported reliance upon an exemption from the registration provisions of the Securities Act. The most noteworthy consequence of dividing into two steps that which had previously been accomplished in one was the following:

UBS and its fellow underwriters would be able to claim immunity from the civil liability provisions of the Securities Act by claiming that they were not involved in the public distribution of the securities. It was for that precise purpose – to evade the banks' involvement in the registration and distribution of those bonds (and evade the concomitant liability exposure) – that the shift to the two-step procedure was recommended by the two bankers—Lorello and McGahan—who knew that HealthSouth was fabricating its financial statements.

353A. To proceed with their plan, Lorello and McGahan proposed to HealthSouth that it abandon the customary practice of selling registered securities through underwriter banks and, instead, rely on an exemption from registration. This exemption is provided in SEC Rule 144A, 17 U.S.C. §230.144A ("Rule 144A"), under which an issuer sells securities to investment banks, which, in turn, sell those securities to QIBs, as defined in the Rule.[6] QIBs generally prefer to buy debt that may be sold without restrictions; however, in order to make the purportedly "private" sale under Rule 144A more attractive to QIBs, and therefore more likely to be successful for the issuer, an issuer often agrees, as a term of the initial sale of securities to the investment banks, to register securities with identical terms, and then to conduct an exchange of those registered securities for the securities initially sold. In this second step, the issuer registers securities with terms identical to those of the initially sold securities, and distributes prospectuses to the holders of the initially sold securities. Once the registration statement is declared effective, the issuer, relying on the exchange structure approved by the SEC in a series of "No Action" letters (beginning with the SEC's May 13, 1998 letter concerning certain facts pertaining to Exxon Capital Holdings Corporation) conducts the

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[6] Of course, as with any exemption from the registration requirements of the Securities Act, anyone relying on Rule 144A has the burden of establishing that such reliance was in "good faith" – a condition plainly absent here given Lorello's and McGahan's design to evade Securities Act liability for the fraud of which they had become aware. *See* Section 19(a) of the Securities Act, 15 U.S.C. §77s(a).

exchange. Under the facts set forth in the Exxon Capital Holdings No Action Letter, a QIB may then sell the registered security without compliance with the registration or prospectus delivery provisions of the Securities Act.

354A. Thus, beginning in 1998, rather than continue to use the tried-and-true customary registration process, as they had done successfully several times in the past, and instead of opting to use the "shelf" registration process permitted under SEC Rule 415 (whereby qualified issuers like HealthSouth file with the SEC a single "shelf" registration statement for securities to be issued to the public on a continuous or delayed basis, and then, when desirable, take such securities "off the shelf" as long as the issuer, among other things, keeps the information in the shelf registration current by filing all required reports), HealthSouth, based on Lorello's and McGahan's plan, divided each public distribution into two parts. In the first "part," HealthSouth sold unregistered debt securities (the "Unregistered Notes") to the Underwriter Defendants pursuant to purchase agreements (the "Purchase Agreements") and registration rights agreements (the "Registration Rights Agreements"). The Underwriter Defendants immediately resold the Unregistered Notes to QIBs using offering memoranda (the "Offering Memoranda")—which Lorello and McGahan knew were materially false and misleading—by which the QIBs became entitled to the benefits of the Registration Rights Agreements. Under the Registration Rights Agreements, HealthSouth explicitly was required to, and did, exchange the Unregistered Notes for notes that were registered with the SEC (the "Registered Notes") and issued pursuant to prospectuses (the "Prospectuses") and Registration Statements (the "Registration Statements"), as required by the Securities Act. The Offering Memoranda, with the exception of a few non-substantive differences in dates and lengths of time, all provided that HealthSouth would prepare and file with the SEC the Registration Statements within two months after the date HealthSouth sold the Unregistered Notes to the Underwriter Defendants, and that, upon

the effectiveness of the Registration Statements, HealthSouth would commence the exchanges with the QIBs.

355A. This two-step structure for a public distribution is generally more burdensome, more expensive and more time consuming for the issuer than the customary one-step public distribution process. At the time HealthSouth was issuing its debt, the costs associated with the two-step Rule 144A structure were more than the costs necessary to conduct a customary registered public debt offering. The higher costs to complete a Rule 144A offering result from at least the following factors:

- To conduct the required second step in the two-step process, that is, the exchange offers, HealthSouth and, according to Owens, SSB and UBS, prepared and filed with the SEC Registration Statements and Prospectuses, and distributed those Prospectuses to holders of the Unregistered Notes. But, unlike registered offerings, HealthSouth's Rule 144A offerings required an additional initial purportedly "private" sale of debt securities. As a result of those additional "private" sales, HealthSouth incurred, in addition to the costs necessary to register the securities, at least the costs of preparing offering memoranda, which were as comprehensive as a prospectus required under Section 10 of the Securities Act, and of negotiating and preparing the necessary purchase agreements and registration rights agreements.

- HealthSouth, in addition to incurring the costs of distributing the Unregistered Notes, which would have been the same as the costs the Company would have incurred to distribute Registered Notes had such offerings been conducted, also had to incur the costs necessary to complete the exchanges of the Registered Notes for the initially issued Unregistered Notes.

- In addition to out-of-pocket costs, HealthSouth also incurred substantially greater costs as a result of the amount of employee attention it had to direct to the exchanges of Unregistered Notes for Registered Notes. HealthSouth employees, including those at senior levels, were required to devote substantial attention to the components of the second step of the process, including the preparation and filing of Registration Statements and prospectuses, distributing prospectuses to the holders of the Unregistered Notes, and coordinating and conducting the actual exchanges, all of which would have been unnecessary had HealthSouth continued to use the customary one-step process.

Thus, by virtue of the exchange, HealthSouth likely incurred greater costs than the Company would have incurred had it availed itself of direct access to the public markets as it had repeatedly and successfully done before the Bond Class Period. And, because the debt was issued indirectly instead

of directly to the public, HealthSouth likely had to price the debt using interest rates higher than those available for debt issued directly to the public by similar companies.

356A. In fact, HealthSouth's conduct – switching from the customary registration structure exclusively to the two-step Rule 144A/*Exxon Capital* exchange structure – was very unusual, if not unique. According to information contained in the Securities Data Company database (and confirmed where available by data from *Bloomberg* and SEC filings), at the time that HealthSouth switched, and continuing throughout the time HealthSouth exclusively used the two-step structure, not one other issuer of debt securities of the size of, and with a debt rating similar to, HealthSouth, and having demonstrated similar access to the public market, used the Rule 144A/*Exxon Capital* exchange structure to sell debt securities during the times and in the manner employed by HealthSouth. That is, not one other publicly-traded "Fortune 500" parent company that (a) was eligible to file an S-3 registration statement, (b) had a Moody's or Standard & Poor's debt rating similar to that of HealthSouth, (c) issued bonds during the same timeframe as HealthSouth and for similar levels of debt, and (d) had previously issued registered debt in standard public offerings, switched its practices like HealthSouth did to sell bonds exclusively through the Rule 144A/*Exxon Capital* exchange structure.

357A. According to Martin, McGahan designed and presented the switch to the "two-step" process to him in early 1998. In proposing this departure from prior practice, McGahan emphasized to Martin that doing so would, among other things, evade the more stringent review the SEC affords registration statements filed for customary offerings, and, in fact, that although a registration statement would be filed in connection with the second step of the two-step process, it was highly unlikely that the SEC would scrutinize that registration statement. The SEC had almost uncovered the fraud when it reviewed the registration statement filed for the stock HealthSouth was to issue in connection with its 1997 acquisition of Horizon, and, according to Martin, no one affiliated with the

transaction wanted the SEC to engage in such rigorous scrutiny of their transactions. McGahan and Lorello presented their proposal for this new method of selling bonds without SEC scrutiny at HealthSouth's March 6, 1998 Board of Directors meeting.

358A. In addition to minimizing SEC scrutiny, Lorello and McGahan's intent was that the Integrated Public Offering Scheme would also allow the Underwriter Defendants to evade:

- the near-strict civil liability for HealthSouth's fraudulent Offering Memoranda, Prospectuses and Registration Statements;
- the "due diligence" investigations that would have been performed in connection with a properly registered public offering of the Notes in order to establish a "reasonable investigation" defense necessary to avoid Securities Act liability, *see* 15 U.S.C. §77k(b)(3); and
- the filing with the SEC of the registration statements necessary for the Notes sold in the "first step" of the scheme, which registration statements would have identified the Underwriter Defendants' as "underwriters" and included their disclosure documents.

359A. As described above, defendants McGahan and Lorello designed and implemented the Integrated Public Offering Scheme. Moreover, they (and their respective banks, first SSB and then UBS) directly participated in ***both*** steps of the Integrated Public Offerings. For instance, Lorello and McGahan and cohorts from SSB or UBS took part in at least the following deceptive acts in furtherance of the Integrated Public Offering Scheme and the Financial Fraud:

- they prepared the materially false and misleading Offering Memoranda knowing that those offering documents included or incorporated HealthSouth's fraudulent financial statements and financial and business information;[7]
- they priced and, together with the other Underwriter Defendants, sold the Notes to their unsuspecting QIB clients using the materially false and misleading Offering Memoranda and road show materials;

[7] Indeed, the Offering Memoranda listed the Underwriter Defendants along with HealthSouth on the cover page.

- they prepared, or substantially and directly participated in the preparation of, the Registration Statements and the Prospectuses and other documents that they knew were materially false and misleading (and concealed their role and participation from the SEC and the investing public); and

- they directly participated throughout the entire public distribution process for each of the six public debt offerings, but concealed their involvement from the SEC and the investing public.

360A. This deceptive conduct had the principal purpose and effect of creating a false appearance of fact in furtherance of the Integrated Public Offering Scheme and the Financial Fraud, including the following:

- concealing from the SEC, the investing public, plaintiffs and Class Members the nature and extent of HealthSouth's fraud to date, as well as HealthSouth's true historical and current financial results and condition;

- introducing into the market HealthSouth Notes that UBS knew were worthless, and thus creating the false appearance that the Notes were properly priced and entitled to be issued to the public; and

- creating the false appearance that the Underwriter Defendants and HealthSouth were entitled to rely on the exemption provided by Rule 144A, and that they had complied with the SEC's regulatory process and requirements.

The Underwriter Defendants Could Not Rely In Good Faith on Rule 144A

361A. Although the Underwriter Defendants purported to rely on Rule 144A in order to break up those public distributions into separate parts, that Rule does not allow for an exemption from registration and related civil liabilities under the Securities Act where—as here—the exemption is not relied upon in good faith, nor is the Rule 144A exemption available where the public distributions were improperly designed and conducted as two-step transactions to evade the registration requirements, including related civil liabilities, imposed under the Securities Act. Accordingly, Rule 144A and the two-step structure addressed in the SEC's Exxon Capital series of No-Action letters were inapplicable to any of the Integrated Public Offerings. As expressly set forth in Preliminary Note 3, Rule 144A does not provide an exemption from registration under the

Securities Act where, as here, the transactions are part of a scheme to evade the Securities Act's registration requirements:

> In view of the objective of this section and the policies underlying the Act, this section is not available with respect to any transaction or series of transactions that, although in technical compliance with this section, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.

SEC Rule 144A, 17 U.S.C. §230.144A (Prelim. Note 3).[8]

362A. Accordingly, none of the so-called "private placements" were truly exempt from registration under the Securities Act, and the Underwriter Defendants cannot rely on the exemption provided by Rule 144A to carve their public distributions into separate "private" and "public" parts.

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[8] Preliminary notes are integral parts of the SEC Rules. As an initial matter, preliminary notes are subject to the rule promulgation and amendment process. For instance, when the SEC publishes proposed rules for public comment, preliminary notes are published by the SEC together with the text of the proposed rule. *See, e.g.*, RESALES OF RESTRICTED SECS., Exchange Act Release No. 33-6806, 1988 WL 1024389, at *32 (Oct. 25, 1988). In addition, the SEC amends preliminary notes and views such amendments as having the same effect as amendments to the text of the rules. *See, e.g.*, PURCHASES OF CERTAIN EQUITY SECS. BY THE ISSUER AND OTHERS, Exchange Act Release No. 34-48766, 2003 WL 22571456, at *5 (Nov. 10, 2003) ("Because we are adopting this sentence as part of the preliminary notes to the Rule, we have decided that it is unnecessary to also include this sentence in paragraph (d) [of the rule], as we had originally proposed."). In fact, Preliminary Note 3, which was not included in Rule 144A when that Rule was originally distributed for comment, was added to Rule 144A during the rulemaking process. Moreover, the SEC, the courts and securities law commentators clearly consider preliminary notes to be an integral part of the rules. *See, e.g.*, PURCHASES OF CERTAIN EQUITY SECS. BY THE ISSUER AND OTHERS, Exchange Act Release No. 33-6862, 46 SEC Docket 26, at *32, n.20 (Apr. 23, 1990) ("The Rule is not available for a transaction that, although in technical compliance therewith, is part of a plan or scheme to evade the registration provisions of the Act. *See* Preliminary Note 3 to Rule 144A"); *SEC v. Parnes*, No. 01 CIV 0763, 2001 WL 1658275, at *7 (S.D.N.Y. Dec. 26, 2001) ("Regulation S did in fact provide notice that exemption would not be available 'with respect to any transactions or series of transactions that, although in technical compliance with these rules, was part of a plan or scheme to evade the registration provisions of the Act.' 17 C.F.R. § 230.901-905, Preliminary Note 2."); *SEC v. Century Mortgage Co.*, 470 F. Supp. 300, 309 (D.C. Utah 1978) ("Rule 147 was not intended to provide a means of circumventing federal securities registration requirements . . . 17 C.F.R. s 230.147, preliminary note 3."); *Gabriel Capital v. Natwest Fin., Inc.*, 94 F. Supp. 2d 491, 504 (S.D.N.Y. 2000) ("Rule 144A makes clear that its restrictive definition is of limited application. *See* 17 C.F.R. § 230.144A, Preliminary Note 1."); *see also* J. WILLIAM HICKS, RESALES OF RESTRICTED SECURITIES §7.3 (2006) ("Rule 144A consists of seven preliminary notes and five paragraphs.").

The distributions must remain integrated and considered together as the public distributions they each were. As a result and as described below, the Underwriter Defendants are underwriters and sellers in connection with all six Integrated Public Offerings, and are subject to liability under Sections 11 and 12(a)(2) of the Securities Act.

363A. Not only was good faith reliance on Rule 144A unavailable, but the SEC's Exxon Capital No Action letter also was inapplicable to any debt issued by HealthSouth. SEC No Action letters provide the SEC's position solely with respect to the particular facts set forth in the letter that requested the SEC's position; all others – including the Underwriter Defendants and HealthSouth – rely at their own risk upon the SEC's stated position. The particular facts here – that Lorello and McGahan knew about the Financial Fraud and devised the Integrated Public Offering Scheme to introduce and distribute HealthSouth's worthless Notes to the market through materially false and misleading Offering Memoranda, Registration Statements and Prospectuses, and that UBS was, in fact, involved in preparing the Registration Statements – certainly eliminates any reliance on the Exxon Capital No Action letter.

The Underwriter Defendants Are "Underwriters" and "Sellers" of the Notes

364A. The Underwriter Defendants priced, offered, sold and solicited the purchase of HealthSouth's Notes. Without the application of the Rule 144A registration exemption to improperly carve HealthSouth's public distributions into two pieces, the Underwriter Defendants are "underwriters," as defined in §2(a)(11) of the Securities Act, and, therefore, are liable as such under §11(a)(5) of the Securities Act with respect to each materially false and misleading Registration Statement. For the same reason, the Underwriter Defendants distributed the Unregistered Notes and the Registered Notes to the public, and, therefore, are liable as "sellers" under §12(a)(2) of the Securities Act with respect to each materially false and misleading Offering Memoranda and Prospectus.

365A. In addition, the March 1998 and June 1998 Registration Statements were prepared by, or with the direct and substantial participation of, defendants Lorello, McGahan and SSB and Underwriter Defendants' counsel on behalf of the whole syndicate, and the September 2000, February 2001, September 2001 and May 2002 Registration Statements were prepared by, or with the direct and substantial participation of, defendants Lorello, McGahan and UBS, and the Underwriter Defendants' counsel on behalf of the whole syndicate.[9] According to Owens, HealthSouth lacked both the manpower and sophistication to prepare and file the Registration Statements and conduct the exchanges without the direct and substantial involvement of defendants Lorello, McGahan, SSB, UBS and the Underwriter Defendants' counsel. Martin also confirmed that HealthSouth relied on its bankers and their counsel in connection with the registration and exchange processes. HealthSouth accordingly relied heavily on those defendants, who participated directly throughout the Rule 144A/*Exxon Capital* exchange process. Thus, even though the Underwriter Defendants claimed to this Court (and in the case of McGahan to Congress) that they had no involvement in the preparation of the Registration Statements or any other facet of the Rule 144A/*Exxon Capital* exchange process after they sold Unregistered Notes to QIBs, SSB, UBS and the Underwriter Defendants' counsel on behalf of the whole syndicate ***were actually involved*** in the registration process even ***after*** the first "step" of the transaction was completed. For example, McGahan, Lorello, SSB, UBS and the Underwriter Defendants' counsel (on behalf of the whole syndicate), among other things, provided HealthSouth and its counsel with substantive comments on drafts of the Registration Statements and Prospectuses, models of registration statements and related

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[9] Unless otherwise specified herein, any reference to the Individual Underwriter Defendants' and SSB's participation and involvement shall refer to and include the March 1998 and June 1998 Registration Statements. In the same manner, all references to UBS's participation and involvement shall refer to and include the September 2000, February 2001, September 2001 and May 2002 Registration Statements.

documents to use in connection with the registration, and guidance with respect to the registration process. By reason of their and their counsel's direct and substantial participation throughout the public distribution of the Notes, the Underwriter Defendants are "underwriters," as defined in Section 2(a)(11) of the Securities Act, of all the Registered Notes. Said defendants therefore are liable—even without integrating the Registered and Unregistered Note offerings—as "underwriters" of all of the Registered Notes pursuant to Section 11(a)(5) of the Securities Act with respect to each materially false and misleading Registration Statement. Similarly, these defendants are liable as "sellers" of all of the Registered Notes under Section 12(a)(2) of the Securities Act with respect to each materially false and misleading exchange offer Prospectus.

The Materially False and Misleading Statements in the Integrated Public Offerings

366A. The first Integrated Public Offering was conducted in March 1998 (the "March 1998 Integrated Public Offering"). The Underwriter Defendants and HealthSouth repeated the process five more times: in June 1998 (the "June 1998 Integrated Public Offering"), in September 2000 (the "September 2000 Integrated Public Offering"), in February 2001 (the "February 2001 Integrated Public Offering"), in September 2001 (the "September 2001 Integrated Public Offering"), and in May 2002 (the "May 2002 Integrated Public Offering"). In total, HealthSouth, the Underwriter Defendants, and Individual Underwriter Defendants Lorello and McGahan sold eight debt securities (the "Notes") in six public debt offerings (two of those offerings were for two debt instruments), each, as described above, improperly divided into two pieces even though there was no right to rely in good faith on the exemption set forth in SEC Rule 144A and the Exxon Capital Holdings Corporation exchange structure.

367A. The Offering Memoranda prepared by the Underwriter Defendants and HealthSouth each incorporated by reference HealthSouth's most recent annual financial statements, as well as any quarterly financial statements the Company filed in the year in which a particular Integrated Public

Offering was conducted. Because the Offering Memoranda were used to sell the Notes in integrated public distributions, they constitute "prospectuses" for purposes of Sections 12(a)(2) and 2(a)(10) of the Securities Act. As set forth below, all of those financial statements were materially false and misleading as a result of the massive accounting fraud committed by HealthSouth and the Individual Defendants. E&Y issued unqualified auditor's reports on each of HealthSouth's annual financial statements. In each of E&Y's auditor's reports, E&Y represented that, based on its audits, which it falsely represented were conducted in accordance with GAAS, the Company's financial statements fairly presented the consolidated financial position of HealthSouth, and were prepared in accordance with GAAP. As described herein, E&Y's unqualified auditor's reports were materially false and misleading.

368A. The Offering Memoranda also contained information concerning a variety of HealthSouth business and operational matters that, for the reasons described in the SAC, were materially false and misleading. For example:

(a) The Offering Memoranda describe that "[s]ubstantially all of [the Company's] revenues are derived from private and governmental third-party payors," which imposed detailed restrictions on the level of reimbursements to HealthSouth. The Offering Memoranda also describe that the Company has "developed [its] operating systems to attempt to ensure compliance with the various standards and requirements of the Medicare program and have established ongoing quality assurance activities to monitor compliance." This was false and misleading because, as described in the SAC, but not disclosed in the Offering Memoranda, HealthSouth's Medicare Fraud cheated governmental and private payors as a result of such devices as applying for the cost of assets that HealthSouth did not own. Also as described in the SAC, due to the Overbilling Fraud, HealthSouth was charging private and governmental payors more for services than the Company was permitted to charge. Further, the Company's false accounting entries often consisted of reducing a contra

revenue account, called "contractual adjustment," a revenue item that estimated the difference between gross charges to patients and the amounts health insurers or the government actually would pay, thereby artificially inflating revenue earnings;

(b) The Offering Memoranda state that HealthSouth has "implemented disciplined financial policies that have resulted in strong cash flows." This was false and misleading because, as described in the SAC, the Company was strapped for cash, and needed the cash from the Integrated Public Offerings in order to continue operations and to pay back loans to certain of the Underwriter Defendants. Further, UBS considered the Company a poor credit and business risk, and sought to limit its exposure to those risks;

(c) The Offering Memoranda disclose HealthSouth's intended use of the proceeds. These statements were false and misleading because, as described in the SAC, none of the Offering Memoranda disclosed that the debt being repaid was being repaid to, among others, entities affiliated with certain of the Underwriter Defendants, nor was it disclosed that the proceeds were going to be used to pay income taxes on the fictitious income HealthSouth reported, or to fill the holes left by the Company's financial manipulations;

(d) The Offering Memoranda describe HealthSouth's facilities as "among the most cost-effective in the industry, making [the Company] an attractive healthcare provider for payors and self-insured employers, and that management believes "that our low-cost profile favorably positions us to respond to reimbursement pricing pressure." These statements were false and misleading because, as described in the SAC, the Company's "low-cost profile" was the result of improperly capitalizing period expenses as assets; and

(e) The Offering Memoranda describe that HealthSouth's net accounts receivable include only those amounts estimated by management to be collectible. This was false and

misleading because, as described in the SAC, HealthSouth failed to write-off more than $500 million in overdue accounts receivable of dubious collectibility.

369A. In addition, as described above, the Offering Memoranda failed to disclose to investors that, at the same time that UBS was a lead underwriter in connection with the Integrated Public Offerings, internally UBS considered HealthSouth a poor credit, had serious concerns about HealthSouth's financial viability and was reducing its own exposure to HealthSouth's credit.

370A. HealthSouth conducted each exchange pursuant to a Prospectus and a Registration Statement, each of which included or incorporated information substantially similar to the information described in the foregoing paragraph, HealthSouth's materially false and misleading annual and quarterly financial statements and financial information, and E&Y's materially false and misleading unqualified auditor's reports on the Company's consolidated annual financial statements.

371A. HealthSouth's six Integrated Public Offerings are described in ¶¶331-65 of the SAC.

DATED: July 19, 2006

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I hereby certify that on July 19, 2006, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system which will send notification of such filing to the e-mail addresses denoted on the attached Electronic Mail Notice List, and I hereby certify that I have mailed the foregoing document or paper via the United States Postal Service to the non-CM/ECF participants indicated on the attached Manual Notice List.

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