

UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF ALABAMA  
SOUTHERN DIVISION

In re HEALTHSOUTH CORPORATION SECURITIES LITIGATION	)	Master File No. CV-03-BE-1500-S
	)	
This Document Relates To: All Actions	)	
	)	
In re HEALTHSOUTH CORPORATION STOCKHOLDER LITIGATION	)	Consolidated Case No. CV-03-BE-1501-S
	)	
This Document Relates To: All Actions	)	<u>CLASS ACTION</u>
	)	
In re HEALTHSOUTH CORPORATION BONDHOLDER LITIGATION	)	Consolidated Case No. CV-03-BE-1502-S
	)	
This Document Relates To: All Actions	)	<u>CLASS ACTION</u>
	)	

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

**DEMAND FOR JURY TRIAL**

## TABLE OF CONTENTS

	<b>Page</b>
INTRODUCTION .....	1
The Scheme.....	3
Ernst & Young’s Participation in the Fraudulent Scheme.....	5
Underwriters’ Knowing Involvement.....	8
Financial Fraud .....	14
Medicare Fraud .....	15
Passage of the Balanced Budget Act and Defendants’ Sale of Stock and Notes.....	16
Defendants Reinflate the Price of HealthSouth Stock .....	19
Transmittal 1753 .....	20
JURISDICTION AND VENUE .....	30
THE PARTIES.....	30
Stockholder Plaintiffs.....	30
Bondholder Plaintiffs .....	32
Defendant HealthSouth.....	33
Senior Officer Defendants .....	33
Employee Defendants .....	40
Director Defendants .....	44
Defendant Ernst & Young .....	49
Underwriter Defendants.....	51
Additional Underwriter Defendants.....	54
Individual Underwriter Defendants .....	59
Summary of Claims Against the Defendants.....	63
Senior Officer Defendants’, Employee Defendants’ and Director Defendants’ Involvement in Scheme.....	64

	<b>Page</b>
Insider Selling .....	67
Healthsouth's Board of Directors Recklessly Allows the Misconduct to Occur and Continue Unabated .....	68
OVERVIEW OF THE SCHEME .....	69
HealthSouth's False Financial Statements .....	70
The SARC Report Provides Further Details of the Accounting Misstatements .....	73
Contractual Adjustments/Improper Classification of Expenses .....	75
Improper Entries on Facilities' Results .....	77
Acquisition Accounting .....	80
Improper Accounting For Bonuses .....	81
Investment Accounting .....	82
Other Accounting Manipulations .....	84
Former HealthSouth Executives Disclose Facts of Wrongdoing .....	89
The Balanced Budget Act of 1997 .....	100
HealthSouth's Overbilling Fraud .....	106
The <i>Qui Tam</i> Actions .....	107
The <i>Devage</i> Action .....	108
The <i>Darling</i> Action .....	111
The <i>Mandel</i> Action .....	111
The <i>Manning</i> Action .....	111
HealthSouth Employees Complained to Their Supervisors About the Overbilling Fraud .....	112
Scrushy Knew that HealthSouth Was Improperly Billing Medicare When He Sold His Stock .....	115
Scrushy Knew that Transmittal 1753 Would Have a Material Impact on HealthSouth's Operations Before Selling His Stock to Repay His Loan .....	116

	<b>Page</b>
The August 27 Press Release Causes HealthSouth Shares to Plunge in Price .....	122
HealthSouth’s Document Destruction .....	127
HealthSouth Falsely Claims Scrushy Is “Cleared” .....	128
DEFENDANTS’ USE OF THE INTEGRATED PUBLIC OFFERINGS TO CARRY OUT THEIR SCHEME – THE INVESTMENT BANKS INVOLVEMENT .....	131
HealthSouth’s Integrated Public Offering Scheme .....	134
The March 1998 Integrated Public Offering .....	137
The June 1998 Integrated Public Offerings .....	139
The September 2000 Integrated Public Offering .....	142
The February 2001 Integrated Public Offering .....	145
The September 2001 Integrated Public Offerings .....	147
The May 2002 Integrated Public Offering .....	150
The Underwriter Defendants Are “Underwriters” and “Sellers” of the Notes .....	152
HealthSouth and the Underwriter Defendants Improperly Exploited the Rule 144A Exchange Structure in a Scheme Intended to Evade the Registration Requirements of the Securities Act .....	158
HealthSouth’s Relationship with UBS, Citi/Salomon and Lorello and McGahan Compels the Inference that They Knew About and Actively Concealed HealthSouth’s Financial Fraud .....	163
Defendants Lorello, McGahan and Capek Had Direct Knowledge of the Fraud at the Very Same Time Citi/Salomon or UBS Provided Investment Banking and Analyst Services for HealthSouth .....	180
ERNST & YOUNG’S PARTICIPATION IN THE MISSTATEMENTS .....	184
E&Y’s Long Term Relationship with HealthSouth .....	185
E&Y’s False Classification of “Pristine Audits” as “Audit-Related” .....	206
FALSE AND MISLEADING STATEMENTS .....	209
False and/or Misleading Statements Issued During the First and Second Quarters of 1997 .....	211

	<b>Page</b>
Reasons Defendants' Statements Issued During the First and Second Quarters of 1997 Were False and/or Misleading .....	212
False and/or Misleading Statements Issued During the Third Quarter of 1997 .....	213
Reasons Defendants' Statements Issued During the Third Quarter of 1997 Were False and/or Misleading.....	216
False and/or Misleading Statements Issued During the Fourth Quarter of 1997.....	216
Reasons Defendants' Statements Issued During the Fourth Quarter of 1997 Were False and/or Misleading.....	218
False and/or Misleading Statements Issued During the First Quarter of 1998 .....	219
Reasons Defendants' Statements Issued During the First Quarter of 1998 Were False and/or Misleading.....	220
False and/or Misleading Statements Issued During the Second Quarter of 1998.....	222
Reasons Defendants' Statements Issued During the Second Quarter of 1998 Were False and/or Misleading.....	225
False and/or Misleading Statements Issued During the Third Quarter of 1998 .....	226
Reasons Defendants' Statements Issued During the Third Quarter of 1998 Were False and/or Misleading.....	231
False and/or Misleading Statements Issued During the Fourth Quarter of 1998.....	232
Reasons Defendants' Statements Issued During the Fourth Quarter of 1998 Were False and/or Misleading.....	234
False and/or Misleading Statements Issued During the First Quarter of 1999 .....	235
Reasons Defendants' Statements Issued During the First Quarter of 1999 Were False and/or Misleading.....	235
False and/or Misleading Statements Issued During the Second Quarter of 1999.....	237
Reasons Defendants' Statements Issued During the Second Quarter of 1999 Were False and/or Misleading.....	239
False and/or Misleading Statements Issued During the Third Quarter of 1999 .....	240
Reasons Defendants' Statements Issued During the Third Quarter of 1999 Were False and/or Misleading.....	242

	<b>Page</b>
False and/or Misleading Statements Issued During the Fourth Quarter of 1999.....	242
Reasons Defendants' Statements Issued During the Fourth Quarter of 1999 Were False and/or Misleading.....	243
False and/or Misleading Statements Issued During the First Quarter of 2000 .....	243
Reasons Defendants' Statements Issued During the First Quarter of 2000 Were False and/or Misleading.....	245
False and/or Misleading Statements Issued During the Second Quarter of 2000.....	247
Reasons Defendants' Statements Issued During the Second Quarter of 2000 Were False and/or Misleading.....	247
False and/or Misleading Statements Issued During the Third Quarter of 2000 .....	248
Reasons Defendants' Statements Issued During the Third Quarter of 2000 Were False and/or Misleading.....	249
False and/or Misleading Statements Issued During the Fourth Quarter of 2000.....	249
Reasons Defendants' Statements Issued During the Fourth Quarter of 2000 Were False and/or Misleading.....	250
False and/or Misleading Statements Issued During the First Quarter of 2001 .....	250
Reasons Defendants' Statements Issued During the First Quarter of 2001 Were False and/or Misleading.....	251
False and/or Misleading Statements Issued During the Second Quarter of 2001.....	252
Reasons Defendants' Statements Issued During the Second Quarter of 2001 Were False and/or Misleading.....	253
False and/or Misleading Statements Issued During the Third Quarter of 2001 .....	254
Reasons Defendants' Statements Issued During the Third Quarter of 2001 Were False and/or Misleading.....	255
False and/or Misleading Statements Issued During the Fourth Quarter of 2001.....	255
Reasons Defendants' Statements Issued During the Fourth Quarter of 2001 Were False and/or Misleading.....	256
False and/or Misleading Statements Issued During the First Quarter of 2002 .....	256

	<b>Page</b>
Reasons Defendants' Statements Issued During the First Quarter of 2002 Were False and/or Misleading.....	257
False and/or Misleading Statements Issued During the Second Quarter of 2002.....	259
Reasons Defendants' Statements Issued During the Second Quarter of 2002 Were False and/or Misleading.....	262
False and/or Misleading Statements Issued During the Third Quarter of 2002 .....	263
Reasons Defendants' Statements Issued During the Third Quarter of 2002 Were False and/or Misleading.....	266
False and/or Misleading Statements Issued During the Fourth Quarter of 2002.....	268
Reasons Defendants' Statements Issued During the Fourth Quarter of 2002 Were False and/or Misleading.....	268
THE TRUTH EMERGES.....	270
The Government Commences a Criminal Investigation.....	270
The Ratings Downgrades and Other Adverse Business Developments .....	270
Reasons Defendants' Statements Re: the Criminal Investigation Were False and/or Misleading .....	272
The SEC Actions and Criminal Cases .....	273
LEGAL THEORIES AND CLAIMS .....	274

## INTRODUCTION

1. This is a joint consolidated class action complaint filed on behalf of all individual and institutional investors who have been victimized by one of the largest and most egregious securities frauds since the enactment of the federal securities laws. Pursuant to the Court's orders of June 24, 2003 and July 19, 2004, this pleading sets forth the factual basis for the claims of those investors.<sup>1</sup> The legal theories and claims of the Stockholder Class (as defined below) and the Bondholder Class (as defined below) are set forth in separate consolidated complaints filed concurrently with this pleading. The Stockholder Class complaint asserts claims for violations of the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") on behalf of all persons (other than defendants) who, between April 24, 1997 and March 18, 2003 (the "Stockholder Class Period"), purchased or otherwise acquired the stock or options of HealthSouth Corporation ("HRC," "HealthSouth" or the "Company"), including HealthSouth securities received in exchange for the stock or options of certain other companies acquired by HealthSouth (the "Stockholder Class"). The Bondholder Class complaint asserts claims for violations of the Securities Act and Exchange Act on behalf of all persons (other than defendants) who, between March 31, 1998 and March 18, 2003 (the "Bondholder Class Period"), purchased or otherwise acquired bonds, notes or other debt instruments issued by HealthSouth (the "Bondholder Class").<sup>2</sup> The defendants for these claims include HealthSouth; a founder and the former Chief Executive Officer, Richard M. Scrushy

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<sup>1</sup> The July 19, 2004 Order limits amendments in this Second Amended Complaint to additional facts contained in the HealthSouth Report on SEC Form 8-K filed on June 1, 2004, appended hereto as Exhibit A. Plaintiffs hereby affirm that, if not so barred, they could have and would have included additional factual allegations further supporting their claims.

<sup>2</sup> Unless otherwise indicated, references in this pleading to "Class Period" shall refer to the period between April 24, 1997 and March 18, 2003. Plaintiffs also incorporate by reference the Exhibits and Appendices filed with the Joint Amended Consolidated Class Action Complaint, filed on January 8, 2004.



(“Scrushy”); other former top officers and directors of the Company; HealthSouth’s former outside accountants, Ernst & Young LLP (“E&Y”); the Company’s investment bankers, including individual lead bankers Benjamin Lorello (“Lorello”) and William McGahan (“McGahan”) and the investment banks at which they managed the HealthSouth account from 1986 to 1999 (at Citi/Salomon, as defined below) and from 1999 to 2003 (at UBS, as defined below); and Howard Capek (“Capek”), a UBS healthcare analyst.<sup>3</sup>

2. In a series of shocking revelations, it has been disclosed that, for many years, HealthSouth was falsifying its reported financial condition and operating results – including its reported revenue, net income, earnings-per-share (“EPS”), assets and stockholders’ equity. HealthSouth has now fired E&Y, and belatedly warned investors not to rely on any of the E&Y-audited financial statements HealthSouth issued as a public company, eliminating more than \$2.8 billion in previously reported net income, and wiping out every dollar of profit ever reported by HealthSouth as a public company. Joel Gordon, who was appointed interim chairman of HealthSouth’s Board of Directors on March 19, 2003, has admitted that the Company’s fraud harmed investors. Gordon testified before Congress on November 5, 2003, that “HealthSouth public stockholders have clearly been harmed by the fraud,” and said the Board “recognize[d] that many of our ... stockholders ... have been hurt by the action of the people who committed the fraud.” Fifteen of the 38 Individual Defendants, including every one of the Company’s Chief Financial Officers, have already pled guilty to criminal violations of the federal securities laws – the largest number of corporate officers at one company ever to admit to criminal wrongdoing at a single company.

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<sup>3</sup> Pursuant to the Court’s September 2, 2003 Memorandum of Opinion and Order, the proceedings in this case are stayed as to defendants who have either been indicted or pled guilty in criminal cases pending in this District until after their respective sentencing.

## The Scheme

3. During the Class Period, at the direction of Scrushy, defendants implemented a pervasive fraudulent scheme to falsify HealthSouth's financial statements in order to meet or exceed "Wall Street" expectations, which were, in fact, projections disseminated by HealthSouth and the investment banks and analysts that were involved in the scheme. The dissemination of false financial results that were manipulated to meet "analyst" estimates concealed HealthSouth's slowing growth rate and the adverse impact of the Balanced Budget Act of 1997 (the "BBA"), artificially inflating the price of HealthSouth's securities. *See App. 12.*<sup>4</sup> Defendants took advantage of HealthSouth's high stock price to acquire other companies in stock-for-stock transactions, and selling over 16.7 million shares of their personal holdings for insider trading proceeds of over \$300 million, while also pocketing millions of dollars more in cash bonuses based on HealthSouth's false profits during the years 1997-2002. *See App. 9.*

4. This massive scheme of fraudulent financial manipulation and falsification included "cooking" HealthSouth's books to meet Wall Street expectations created by HealthSouth. At the end of every month and every quarter, HealthSouth's top financial officers would provide Scrushy with HealthSouth's actual (but not yet publicly reported) results of operations. When Scrushy and his top lieutenants saw that actual results were well below forecasted results and those necessary for the scheme to continue, Scrushy and HealthSouth's then-CFO would direct accounting subordinates to "fix" the shortfall through the entry of false accounting entries to create made-up revenue and

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<sup>4</sup> In the interest of brevity, plaintiffs have also filed two documents which contain additional detailed facts to support the allegations. These documents are entitled "Appendices to Joint Amended Consolidated Complaint for Violations of the Federal Securities Laws" ("App.") and "Exhibits to Joint Amended Consolidated Complaint for Violations of the Federal Securities Laws" ("Ex.").

income on HealthSouth's records. This was known internally at HealthSouth as "shoveling dirt into the hole."

5. In order to accomplish accounting falsifications of this size and scope, it was necessary for HealthSouth's financial personnel to have regular meetings to coordinate their efforts to "fix" the financial results. By 1997, the individuals who attended these meetings became known within the upper echelons of HealthSouth – and eventually UBS – as "family" members, and the meetings became known as "family meetings." At these meetings, "family" members discussed and agreed upon the amount of "dirt" to fill the holes in HealthSouth's financial results. The operations personnel recording the false "management entries" referred to those falsifications as "gifts," "pixie dust," "fairy dust" or "candy."

6. Defendants also inflated HealthSouth's financial results by systematically over-billing for group therapy sessions as individual therapy (the "Overbilling Fraud"). This was illegal under applicable Medicare regulations and also resulted in an overcharge to private insurance payors that utilized Medicare reimbursement rules, and rate schedules in their contracts with HealthSouth. The Overbilling Fraud made HealthSouth's reported revenues and earnings materially false and misleading.

7. This multi-year scam could not have been, and was not, perpetrated only by HealthSouth and its insiders. Rather, HealthSouth's outside accounting and investment banking firms were knowing participants in the scheme. Working very closely with McGahan's and Lorello's investment banking firms, Citi/Salomon (until 1999) and UBS (after 1999), and its outside auditors, E&Y, HealthSouth by 2002 completed more than twenty acquisitions by issuing 237 million HealthSouth shares, which leaped to a high of about \$31 per share in early 1998. For their part, Citi/Salomon and UBS pocketed millions of dollars in fees for helping HealthSouth arrange its stream of acquisitions, and selling its securities to the public. HealthSouth thus grew into a highly

lucrative investment banking client of these firms – enabling Lorello, McGahan and later Capek to earn millions of dollars in compensation each year. By the end of 1999, as a result of its acquisition binge, HealthSouth was reporting annual revenues and net income exceeding \$4 billion and \$350 million, respectively, and had grown into the nation’s largest provider of outpatient surgery and rehabilitative services. See App. 8. From 1996 through June 30, 2002, HealthSouth reported aggregate profits exceeding \$2.7 billion, all audited and/or reviewed and approved by E&Y, which pocketed millions of dollars of fees each year as HealthSouth grew into the largest client of E&Y’s Birmingham, Alabama office.

### **Ernst & Young’s Participation in the Fraudulent Scheme**

8. E&Y knowingly turned a blind eye to the very fraudulent and illegal practices by which HealthSouth falsified its financial statements and cheated Medicare and private insurers. Indeed, as alleged in detail below, as early as 1994, E&Y learned of HealthSouth’s practice of reporting fictitious revenues and earnings, but chose to “turn its head” to retain the Company as a lucrative client:

(a) By early 1994, E&Y knew that the Company had wrongfully overstated 1993 earnings by \$27 million, through three improper activities: (i) overstating revenue by shifting extraordinary revenue items into ordinary recurring revenues; (ii) understating its allowance for contractual adjustments – the difference between the amount HealthSouth bills payors for services and the amount it expected to be paid for those services; and (iii) under-accruing expenses, thereby deferring those expenses to later periods. As E&Y concluded its audit of HealthSouth’s 1993 financial statements, the E&Y audit engagement partner, defendant G. Marcus Neas (“Neas”), informed a senior executive of HealthSouth that HealthSouth must acquiesce to E&Y’s accounting treatment of \$3 million in investment banking fees because E&Y had looked the other way on the \$27 million earnings overstatement. Specifically, Neas told that HealthSouth senior executive, in

words, or substance: “Don’t question me on this; I turned my head on the \$27 million.” While the amounts of the overstatements grew far greater in later years, the accounting shenanigans known to E&Y in early 1994 remained substantially the same throughout the Class Period. HealthSouth systematically falsified its allowances for contractual adjustments or contractual accounts, and understated its expenses. Thus, E&Y had actual knowledge of the ongoing and pervasive fraud at HealthSouth since at least 1994.

(b) Similarly, on March 9, 1995, the Center for Financial Research & Analysis issued a report on HealthSouth which concluded that there were operational concerns and a weak control environment at HealthSouth and that the Company engaged in aggressive accounting for acquisitions and for startup and related costs. A copy of that report was attached to an internal E&Y memorandum from James P. Conley to Neas who, as noted previously, was aware from his work as the E&Y audit engagement partner that HealthSouth was falsifying its earnings and assets.

(c) E&Y profited directly from turning a blind eye to the financial wrongdoing at HealthSouth, and sought to conceal some of this profit by mislabeling payments as audit related services. In this regard, as part of a program commenced in 1996 at Scrushy’s insistence and with the Board’s approval, E&Y was hired and paid tens of millions of dollars by HealthSouth to check the cleanliness and physical appearance of HealthSouth’s approximately 1,800 surgical and rehabilitation facilities. Despite its name, the “Pristine Audits,” had nothing to do with audits of the Company’s financial statements. Rather, they just enabled E&Y to increase sharply its billings to HealthSouth. Indeed, in some years, HealthSouth paid E&Y more for the Pristine Audits than it paid for year-end financial statement audits. E&Y then compounded its wrongdoing by having HealthSouth misleadingly classify the payments for the Pristine Audits as “Audit-Related Fees” in the Company’s public filings.

9. Further evidence concerning E&Y's central role in the fraud came to light in related criminal proceedings pending in this District before the Honorable Inge P. Johnson, captioned *U.S. v. Emery Harris*, Case No. CR-03-J-157-S and *U.S. v. Ayers, et al.*, Case No. CR-03-J-183 ("Harris Proceedings"). On November 12, 2003, Emery Harris, a defendant in this litigation who was Group Vice President, Accounting and Assistant Controller for HealthSouth from March 2000 to March 2002, testified that E&Y had regularly turned a blind eye to material issues during the course of its audits of HealthSouth's financial statements. In sworn testimony, Harris detailed how E&Y, after discussions with HealthSouth's senior management, systematically issued unqualified auditor's reports on HealthSouth's financial statements when, in fact, E&Y had open audit questions on those financial statements and concerns about the accounting practices being utilized by the Company. Harris also testified that the accounting fraud at HealthSouth should have been "obvious" to E&Y, and that the only rational explanation for E&Y's failure to expose the fraud was a desire by E&Y to avoid jeopardizing its highly lucrative relationship with a long-standing client.

10. Michael Vines, another former HealthSouth employee, testified before the House Committee on Energy and Commerce ("E&C Committee") on October 16, 2003. Vines was employed in the Asset Management Department from April 1997 through May 2002. He testified that he knew that certain accounting personnel at HealthSouth were making improper accounting entries, including falsifying records regarding fixed assets purportedly acquired by HealthSouth. In June 2002, a month after he left HealthSouth, Vines sent E&Y an e-mail detailing various accounting improprieties at HealthSouth, including the illegitimate transfer of expenses into capital accounts, and the existence of fictitious expenses and assets. E&Y never contacted Vines to discuss the improprieties identified in his email.

11. As the Special Audit Review Committee (“SARC”)<sup>5</sup> noted in its May 28, 2004, forensic accounting report (“SARC Report”) attached as an Exhibit to a Form 8-K filed on June 1, 2004:

The magnitude of the fraud and the length of time over which it occurred inevitably raise questions about the role, responsibilities, and effectiveness of the Company’s former outside auditors.

That report further indicated that the full extent of the wrongdoing may never be known due, in part, to “the unavailability of certain corporate records” and “the Company’s e-mail retention practices, which ha[ve] resulted in the elimination of most electronic communications generated during the period under investigation.”

#### **Underwriters’ Knowing Involvement**

12. As alleged herein, the Underwriter Defendants (defined below) are directly liable to the Stockholder Class and Bondholder Class for making materially false and misleading statements in Registration Statements and Prospectuses utilized by HealthSouth and its investment banks to raise billions of dollars of new capital for HealthSouth and for materially false and misleading statements in analysts’ reports written and issued by Citi/Salomon or UBS, which artificially inflated the trading price of HealthSouth’s publicly traded securities.

13. Keeping HealthSouth’s stock price inflated was vitally important to UBS and Citi/Salomon for they knew that if the stock price fell, it would reduce HealthSouth’s shareholders’ equity by hundreds of millions, if not billions, of dollars; endanger the Company’s investment-grade

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<sup>5</sup> On March 22, 2003, HealthSouth’s board of directors established the SARC and directed it to conduct an independent forensic investigation of accounting irregularities at HealthSouth. Jon F. Hanson, then one of only two board members who had not served when the events under investigation occurred, was named chair of the SARC. The SARC was assisted by legal counsel and by a forensic accounting team from PricewaterhouseCoopers LLP and AlixPartners LLC.

credit rating; would likely cut off its access to the capital markets; and thus endanger the ongoing scheme from which UBS, Citi/Salomon and its top partners were profiting.

14. As detailed herein, HealthSouth needed constant infusions of new capital to help cover up the true (and undisclosed) poor state of its operations, to pay taxes on fictitious revenue and to help fund its growth by acquisitions scheme. HealthSouth had to report strong revenues and profits to enable it to sell new securities to the public to support its stock price, to permit acquisition after acquisition, which, in turn, helped generate the apparent growth necessary to keep the overall scheme going. Therefore, a symbiotic relationship with the banks and their analysts was a vital necessity – HealthSouth and its insiders could not pull off the massive scheme alone. The defendants at HealthSouth therefore made certain that their relationship with the Company’s investment banks was as close as possible – a goal accomplished by making it a very lucrative relationship for the lead individual investment bankers, Lorello and McGahan, and their employees at Citi/Salomon and UBS. Working side-by-side on an almost daily basis during the Class Period with these bankers at Citi/Salomon and later UBS (after 1999), HealthSouth completed scores of acquisitions – adding hundreds of millions of dollars in annualized revenues and selling more than \$4 billion in new securities to investors via Citi/Salomon and UBS, which pocketed millions in fees for helping HealthSouth arrange its stream of acquisitions and selling its securities to the public. HealthSouth naturally grew into a highly lucrative investment banking client of these firms. The phenomenal financial rewards to Citi/Salomon and later UBS flowed down, as planned, to Lorello, McGahan and Capek, who earned millions of dollars each year from the incestuous relationship.

15. Although the HealthSouth scheme was very lucrative, it was not without its glitches. Each time a “glitch” arose, however, Citi/Salomon and/or UBS stepped up to the plate to help HealthSouth lie its way through the problem. For example, by early 1997, passage of the BBA had become inevitable. To continue the scheme and conceal the negative impact of the BBA, defendants



lied to the investment community about the consequences the BBA would have on HealthSouth's business and finances. UBS also lied to investors in order to artificially inflate HealthSouth's stock with July 1997 analysts' reports that represented "we anticipate a continuation of the company's solid gains," due to the "company's robust earnings record [and] strong management team" and that any BBA changes would have "no impact on HealthSouth's results" and not "result in earnings estimate revisions," enabling "the company to maintain 24% earnings growth." UBS characterized HealthSouth during the early 1997 time period as a company with "tight cost controls," a "good quality growth story; with EPS growth expected to average 20%-25%." Rating HealthSouth a "strong buy," UBS cited HealthSouth's "robust earnings track record, strong management team ... and the ability to integrate a constant stream of acquisitions." Citi/Salomon also strongly recommended purchase of HealthSouth shares during this time period after the BBA was proposed, citing HealthSouth's "rock-solid fundamentals," "financial strength," which would lead to "strong EBITDA growth in the upcoming years." According to Citi/Salomon, HealthSouth "has saved the Medicare program approximately \$150 million and will generate an additional \$1.5 billion more in the upcoming five years ... by reducing its cost structure to the minimum amount possible." Citi/Salomon said HealthSouth's reduced costs were "due to its internal compliance programs ... an extensive internal control system to monitor legal, accounting and accounts payable functions ... dedicated to eliminating any accounting or operational irregularities." So that "unlike other healthcare service operators which have been plagued by federal investigations related to reimbursement and operating procedures, HealthSouth has long been in good standing at the national healthcare agencies." As detailed herein, these statements were false.

16. As a result of these false statements, HealthSouth stock soared from \$15 in July 1996 to \$29 by July 1997 and to its all-time high of \$31 in April 1998. Citi/Salomon, Lorello and McGahan took quick advantage of the artificial inflation they helped create by assisting HealthSouth

to sell to investors more than \$1 billion in new HealthSouth notes via a fraudulent offering structure using documents that between March 1998 and September 1998 contained further false statements about HealthSouth's business and financial results. This resulted in pocketing millions in fees for Citi/Salomon, (and huge salaries for Lorello and McGahan), while providing the desperately needed fresh capital that HealthSouth needed to stay afloat so defendants' self-enriching scheme could go on. And the scheme did go on – quite successfully. See Apps. 7, 10.

17. Between 1999 and mid-2002 alone, Scrushy and his cohorts created more than \$2.5 billion in phony HealthSouth profits, overstated HealthSouth's assets by more than \$800 million and even covered up its deteriorating financial condition by overstating its cash balances at June 30, 2002 by some \$300 million. During this same time period, UBS constantly rated HealthSouth stock a "strong buy," and Citi/Salomon repeatedly rated the stock a "buy," while issuing glowing reports on the Company, extolling the skill of its management team, the integrity of its financial reports, the strength of its business and the Company's excellent future outlook. See App. 6

18. UBS, Citi/Salomon, Lorello, McGahan and Capek were knowing participants in the wrongdoing. Defendants Lorello, McGahan and later Capek had direct knowledge of the fraudulent nature of HealthSouth's accounting at the very same time their employer, be it Citi/Salomon or UBS, was helping HealthSouth arrange its stream of acquisitions, selling billions of dollars of HealthSouth securities to investors, and issuing glowing analyst research reports, often "strongly" recommending that investors buy HealthSouth securities. See App. 10. The facts evidencing this knowledge include the following:

(a) McGahan had personal knowledge of the financial fraud by no later than the Summer of 1999. In or about June or July 1999, HealthSouth was on track to miss its earnings target for the year by approximately \$280-\$300 million. In the past, HealthSouth had made false acquisition-related entries to provide cover for their overstatements of revenue and earnings.

Accordingly, the Company was desperately looking to make another acquisition to cover up this gaping hole in its financial statements. At that time, however, there were very few, if any, appropriate acquisition candidates in HealthSouth's business sector. Thus, HealthSouth began to look at high-end nursing homes, and ultimately decided on HCR-Manor Care as a potential acquisition candidate. Senior executives of HealthSouth were concerned that a due diligence investigation conducted by the prospective merger partner would uncover HealthSouth's financial manipulations. In June or July 1999, after UBS was retained to act as HealthSouth's investment banker for this prospective acquisition, a senior executive of HealthSouth told McGahan that HealthSouth had been systematically falsifying its financial statements, explained the manner in which the fraud was being accomplished, and stated that the Company was on track to miss earnings estimates for that year by \$280 to \$300 million. None of this information surprised McGahan, who promptly agreed with the senior HealthSouth executive's request that he (McGahan) help him persuade Scrushy not to proceed with the acquisition. McGahan, Scrushy and other HealthSouth executives agreed that HealthSouth should abandon its plans to acquire HCR-Manor Care. Even if McGahan was previously unaware of the scheme at HealthSouth, as a result of this conversation with the senior executive, McGahan and UBS had actual knowledge of the nature and scope of the financial fraud as of mid-1999.

(b) In or about the Summer of 2001, Capek acknowledged to a business acquaintance familiar with HealthSouth's operations that he (Capek) knew that HealthSouth had been improperly capitalizing expenses as part of its scheme to inflate its earnings. When asked by the acquaintance about how HealthSouth was performing, Capek told the acquaintance, in words or substance: "The Company is going to have to stop capitalizing expenses." That Capek would be loyal to Scrushy is hardly surprising as UBS invited Scrushy to select the analyst to issue reports on the Company once the prior analyst had left that post; UBS hired Capek at specific direction of

Scrushy, who was pleased with the reports Capek had issued on HealthSouth while an analyst at Credit Suisse. While he had a “Strong Buy” recommendation on HealthSouth, UBS analyst Capek privately told a favored client in writing that because HealthSouth was “a mess” and a “pig” he “would not own a share of this stock,” yet at the very same time Capek was publicly extolling 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. See Apps. 6, 11, 12.

(c) In addition, from 1999 through at least the Fall of 2002, McGahan had regular conversations with at least one former HealthSouth official who had participated in the fraud 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 follow from such prosecution, including the possibility that McGahan and senior HealthSouth executives could go to prison.

(d) Lorello also was aware of the fraud at HealthSouth, and indeed, affirmatively took steps to insure that the “family members” continued to report false earnings. Among the facts evidencing Lorello’s knowledge of, and involvement in, the wrongdoing were that, as McGahan testified before Congress, he kept Lorello informed about all HealthSouth matters, and, as Harris testified at his sentencing hearing, he and his accounting team listened to a voicemail message to Martin, the then-CFO of the Company, from “Ben” at “U[B]S Warburg” (understood to be Ben Lorello), 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.” See Transcript of November 12, 2003 Sentencing Hearing (“H.R.”) (Ex. C) at 158:5-19.

## Financial Fraud

19. The accounting falsifications and manipulations at HealthSouth were pervasive. HealthSouth senior accounting personnel made thousands of false journal entries to HealthSouth's income statement and balance sheet accounts, created and falsified documents to support fictitious accounting entries, and doctored account ledgers for the Company's health facilities to include assets that simply did not exist. There was no factual or accounting justification for these entries. By June 30, 2002, in reports filed with the Securities and Exchange Commission ("SEC"), HealthSouth's fixed assets, known as property, plant and equipment, were overstated by more than \$1 billion; total assets were inflated by \$1.5 billion; the consolidated balance sheet included more than \$300 million in cash that did not exist; and "Income Before Income Taxes and Minority Interests" had been artificially inflated by at least \$2.7 billion, as follows:

Income (Loss) Before Income Taxes and Minority Interests (in millions)	1996 Form 10-K	1997 Form 10-K	1998 Form 10-K	1999 Form 10-K	2000 Form 10-K	2001 Form 10-K	6 mos. ended 6/30/02	Total
As reported	\$440	\$601	\$267	\$230	\$559	\$434	\$337	\$2,869
Actual Amounts	\$370	(\$99)	(\$283)	(\$160)	\$209	(\$16)	\$107	\$ 129

20. The false accounting entries often consisted of reducing a contra revenue account called "contractual adjustment," which is a revenue account that estimated the difference between gross charges to patients and the amounts health insurers or the government actually would pay, thereby artificially inflating earnings. The amount of these entries to the contractual adjustments account were arbitrary, designed solely to increase bottom-line earnings to meet Wall Street analysts' expectations that the HealthSouth defendants and its investment bankers had created. The constant manipulation of contractual adjustments resulted in massive – and artificial – increases in HealthSouth's revenues, earnings and assets.

21. In order to conceal and avoid the required recognition of millions of dollars of actual current period operating costs, HealthSouth recorded ordinary operating expenses as assets. Specifically, HealthSouth improperly misclassified operating expenditures as the purchase of plant,

property and equipment (also known as “PPE” expenses) to be depreciated over time rather than expensed in the current period – a manipulation that reduced current-period operating expenses and further inflated profits. Another part of the fraud was to continue to carry on HealthSouth’s books assets it no longer owned (*e.g.*, corporate stock in companies it had sold), and not to write off more than \$500 million in overdue accounts receivable of dubious collectibility, further inflating HealthSouth’s profits.

### **Medicare Fraud**

22. HealthSouth’s revenues were largely dependent upon reimbursement from Medicare and private health insurance payors for the services HealthSouth provided patients. However, the federal government and private insurance payors imposed detailed restrictions on the level of reimbursements to healthcare providers, as well as on the types of care that would be reimbursed. These restrictions constrained HealthSouth’s ability to consistently achieve real profits of substantial size.

23. With the knowledge of its outside accountants and investment bankers, HealthSouth compounded the financial fraud by systematically cheating the federal Medicare reimbursement program out of hundreds of millions of dollars. For instance, in addition to paying costs for patient treatment, Medicare reimburses health care providers like HealthSouth for part of the costs of their facilities (*e.g.*, hospital rooms, equipment), based on the proportion of use by Medicare patients. Here, HealthSouth created fictitious PPE expenses – based upon hospital rooms, equipment, etc. that did not exist – which were allocated among its 1,800 plus health care facilities. Those facilities then filed for reimbursement from Medicare for that portion of PPE expenses that was “attributable” to Medicare patients. As Medicare accounted for nearly one-third of HealthSouth’s revenues, the Company would have received Medicare reimbursement for a substantial portion of the \$1.0 billion

in PPE expenses during the Class Period, absent instructions to each facility to exclude these suspect PPE expenses from their filings with the Government.

24. In addition, HealthSouth illegally overcharged Medicare for services that HealthSouth had not provided, by causing the Company's employees to systematically "upcode" the billing for group therapy sessions as individual sessions (the Overbilling Fraud). As a healthcare provider, HealthSouth is required to comply with federal regulations governing billing for services to patients covered by Medicare and other federal reimbursement programs. For many years, the federal government has had separate billing procedures and codes distinguishing between individual and group therapy sessions, with decidedly higher rates of reimbursement being paid for individual rather than group therapy sessions. However, contrary to these rules and regulations, HealthSouth systematically caused its physical therapists and other employees at its over 1,800 facilities to illegally overcharge Medicare for group therapy sessions at the decidedly higher individual therapy rates.

25. These massive overcharges also affected private insurance payors that "piggy-backed" onto the Medicare reimbursement rules, restrictions and rate schedules. HealthSouth deliberately overestimated and over-accrued the amounts it would receive from these carriers, thereby causing its reported revenues and profits to be further artificially inflated. By systematically overcharging Medicare and private insurance payors, inflating revenues, and failing to record expenses, HealthSouth repeatedly reported revenues, profits, assets, EPS and shareholders' equity that were materially overstated by billions of dollars.

#### **Passage of the Balanced Budget Act and Defendants' Sale of Stock and Notes**

26. By 1996-97, HealthSouth's ability to grow by acquisition became increasingly difficult. To make matters worse, during early 1997, Congress was considering the BBA, which sought to refine the procedures for, and decrease federal spending on, entitlement programs such as

Medicare. Because of HealthSouth's dependence on Medicare reimbursement, and the fact that, when enacted, the BBA would have a material adverse impact upon HealthSouth's business and financial performance, Scrushy and HealthSouth's other insiders closely followed every aspect and detail of the development of the BBA, and caused HealthSouth to spend millions of dollars opposing its enactment.

27. By mid-1997, when passage of the BBA had become inevitable, several Company executives urged Scrushy to bring the fraudulent scheme and financial falsification to a halt and operate HealthSouth in an honest manner. Scrushy, a domineering executive known for his violent temper, intimidating manner and arbitrary mistreatment of subordinates, refused to do so. Scrushy rejected such pleas, stating in words or substance: "we aren't stopping until I sell my stock." Thus, to enable Scrushy and other HealthSouth executives to sell large amounts of their HealthSouth stock at inflated prices, and to allow HealthSouth to raise desperately needed cash through new public offerings of securities, defendants caused HealthSouth and the investment banks involved in the scheme to issue a series of public statements that falsely represented that HealthSouth "will emerge relatively unscathed" from the BBA, that the BBA "would not have any adverse impact" on HealthSouth's earnings, would not "result in earnings estimate revisions," that HealthSouth's "financial performance remains strong," and that HealthSouth's "earnings will grow at a rate of 25% for the next 3-5 years."

28. For its part, Citi/Salomon strongly recommended the purchase of HealthSouth shares, citing the Company's "rock-solid fundamentals" and "financial strength," which would lead to "strong EBITDA growth in the upcoming years." According to Citi/Salomon, HealthSouth "has saved the Medicare program approximately \$150 million and will generate an additional \$1.5 billion more in the upcoming five years ... by reducing its cost structure to the minimum amount possible." In fact, according to Citi/Salomon, HealthSouth's reduced costs were "due to its internal compliance



programs ... an extensive internal control system to monitor legal, accounting and accounts payable functions ... dedicated to eliminating any accounting or operational irregularities.” Based on the foregoing, Citi/Salomon concluded that, “unlike other healthcare service operators which have been plagued by federal investigations related to reimbursement and operating procedures, HealthSouth has long been in good standing at the national healthcare agencies.”

29. As a result of HealthSouth’s false financial statements (audited and/or reviewed and approved by E&Y) and assurances of business and financial success, HealthSouth shares soared from \$15 per share in July 1996, to \$29 per share by July 1997, and to its all-time high of \$31 per share in April 1998. With HealthSouth shares selling at or near their all-time highs during late 1997 and 1998, Company executives unloaded almost 6.2 million of their shares of HealthSouth stock at prices between \$26-\$30 per share, pocketing almost \$166 million in illegal insider trading proceeds. Scrushy himself sold 4 million shares at \$27 per share, for gross proceeds of \$108 million. And, in March 1998 and September 1998, Lorello, McGahan and their then-investment banking firm, Citi/Salomon, sold to investors more than \$1.5 billion in new HealthSouth notes through fraudulent use of an SEC regulation exemption and offering documents containing patently false statements about HealthSouth’s business and financial results, all audited and/or reviewed and approved by E&Y. These sales of securities to the investing public enabled Citi/Salomon to pocket millions of dollars in fees and provided HealthSouth with the desperately needed fresh cash it needed to stay afloat.

30. By the Fall of 1998, it became apparent to Scrushy and other HealthSouth executive defendants that they could no longer conceal the BBA’s negative impact on HealthSouth’s earnings and operations. Thus, in the Fall of 1998, Scrushy and other HealthSouth executive defendants caused HealthSouth to report a \$300 million revenue shortfall, and to lower forecasted revenue and profit growth, attributing both to the adverse impact of the BBA.

### **Defendants Reinflate the Price of HealthSouth Stock**

31. As a result of these revelations and HealthSouth's reporting in early 1999 of poorer than previously forecasted net income and EPS, HealthSouth shares declined to as low as \$5-\$6 per share in the Fall of 1999. This decline in the price of HealthSouth shares destroyed the value of HealthSouth executives' stock options, and made acquisitions using HealthSouth stock as currency impossible.

32. But Scrushy and his cohorts did not stop their fraudulent practices. Rather, they continued their fraudulent scheme and course of conduct of over-charging Medicare and private insurance payors, and falsifying and manipulating HealthSouth's financial condition and results, utilizing the same tactics and techniques they had become expert at employing. Also, to help manipulate HealthSouth's stock price higher from September 1998 through March 31, 2000, Scrushy and HealthSouth's other top executives used \$363 million of HealthSouth corporate funds to repurchase 38 million shares of HealthSouth stock on the open market. Then, they spent an additional \$32 million to repurchase four million more shares in mid-2002, even though they knew that HealthSouth shares were not worth the prices that the Company was paying.

33. Furthermore, during 1998-2002, in six offerings with the help of E&Y, UBS, and Citi/Salomon, HealthSouth sold \$3.4 billion in HealthSouth notes to investors to raise the fresh cash necessary to keep the scheme going. These securities sales to investors were possible only through fraudulent use of SEC registration exemption and because HealthSouth's audited financial results and apparent financial strength, business success and forecasts of continued profitable growth were the result of constant manipulation of HealthSouth's financial results to show profits when there were none.

34. Based upon HealthSouth's consistent reporting of strong net income, revenues, EPS, and shareholders equity, which Scrushy and HealthSouth's investment bankers falsely attributed to a

strong management team, cost control measures and a successful integration of acquisitions, the price of HealthSouth stock increased by more than 300% from its Fall 1999 lows of about \$5-\$6 per share, to more than \$18 per share in August 2001. Scrushy and other HealthSouth executive defendants used HealthSouth's inflated stock prices as yet another opportunity to engage in insider trading, dumping more than 2.3 million additional shares of their HealthSouth common stock for some \$27 million in illegal insider trading proceeds during the period April 2000 through December 2001.

### **Transmittal 1753**

35. For years, one important Medicare procedure used to control costs was separate billing procedures and codes distinguishing between individual and group therapy sessions, with much higher rates of reimbursement being paid for individual therapy sessions. However, one of the ways HealthSouth had been cheating Medicare and inflating its revenues and profits by millions of dollars for years had been to charge individual rates for group therapy treatments often by using unqualified, untrained personnel or "extenders." In fact, this very practice was the subject of several *qui tam* lawsuits filed against HealthSouth, including one such suit filed in August 1998 in Texas federal court. Despite the filing of the *qui tam* lawsuits, as well as the repeated complaints by HealthSouth supervisory employees that they were being compelled to participate in Medicare fraud, HealthSouth's top executives continued to cause HealthSouth to violate Medicare regulations. In fact, the Company's proprietary billing system did not even permit the thousands of HealthSouth physical therapists located across the nation to record charges for group (as opposed to individual) therapy sessions.

36. In December 2001, the United States Department of Justice (the "DOJ") notified HealthSouth that it was going to intervene in the *qui tam* suit referred to above. When the DOJ later joined that suit, UBS, where Lorello, McGahan and Capek then worked, downplayed the suit as

“sensationalism,” and characterized the event as “operationally non-material,” as “the practices in question are industry standard and covered by state-level regulation.” Similarly, Citi/Salomon, reiterating its “buy” rating, further assured investors that HealthSouth’s conduct “is industry practice,” and involved conduct “for which there is no federal standard.”

37. In early 2002, defendants learned that Medicare’s Center for Medicare and Medicaid Services (“CMS”) was about to issue regulations which would reaffirm that group therapy sessions must be billed as such, not as individual sessions, as HealthSouth had been doing for years. Although Scrushy and his cohorts knew that HealthSouth’s systematic practice of overbilling Medicare for group therapy sessions as though they were individual therapy sessions would therefore finally have to come to an end, and result in a material adverse impact on HealthSouth’s reported earnings, defendants continued to cause HealthSouth to issue inflated estimates of the Company’s revenues and earnings during 2002 to enable Scrushy and others to sell additional shares of HealthSouth stock at artificially inflated prices.

38. Indeed, just days after defendants pushed HealthSouth stock toward its 2002 high of \$15.89 per share through, among other acts, representations by Scrushy on May 2, 2002 that HealthSouth stock should be “north of \$20 per share right now” based on the Company’s “growth rate” and “strong cash flow,” and within weeks of the May 17, 2002 issuance of Transmittal 1753 by CMS which reaffirmed that group therapy sessions had to be billed as such and not as individual therapy – Scrushy, with the assistance of UBS, unloaded 5,275,360 shares of HealthSouth stock at \$14 per share, pocketing \$74 million in gross proceeds. When knowledge of this sale became public, HealthSouth claimed it was for “personal estate planning and financial diversification reasons.” Later, on July 31, 2002, Scrushy used another 2.5 million shares of inflated HealthSouth stock to repay the principal of a \$25 million loan Scrushy received from the Company (the “Loan”).

39. During the Class Period, HealthSouth insiders also took advantage of the Company's inflated stock price, dumping over 17 million shares for gross proceeds of \$305 million. Likewise, during the time they were unloading their HealthSouth shares, HealthSouth's top executives spent more than \$250 million of HealthSouth's cash to repurchase four million shares of HealthSouth common stock on the open market to keep the market price of HealthSouth shares inflated.

40. In mid-2002, HealthSouth senior officers reiterated to Scrushy their concern about continuing the scheme in light of the new and increased consequences for violating the August 14, 2002 financial statement certification required under the Sarbanes-Oxley Act, SEC Order No. 4-460, Requiring the Filing of Sworn Statements Pursuant to §21(a) (1) of the Securities Exchange Act of 1934 (June 27, 2002) ("Order 4-460"). However, as he had done in the past, Scrushy rejected those pleas and arguments.

41. HealthSouth and its banks worked furiously to put together a plan to take HealthSouth "private" – whereby it would no longer be a public company, no longer have to report its financial results publicly and no longer be subject to SEC oversight – all in hope to conceal their massive multi-year scheme which resulted in billions of dollars in reported false profits. Also, UBS and Citi/Salomon, working with Scrushy and HealthSouth's other top executives and E&Y, put together a \$1 billion offering of notes that closed in May 2002 – providing HealthSouth with the cash necessary either to help fund a going private transaction or allow HealthSouth to stay afloat if it remained a public company – again improperly invoking a SEC registration exemption.

42. On August 7, 2002, HealthSouth reported very strong financial results of \$57 million net income (\$0.14 EPS) for the 2nd Quarter ending June 30, 2002. In reporting HealthSouth's 2nd Quarter results, Scrushy said HealthSouth's results reflected "strength across all product lines," with each business line "demonstrating continued positive volume ... trends," which showed "the success we are having under the new Prospective Payment System." He also assured investors that

HealthSouth would “comply with all ... SEC and New York State Exchange corporate accountability ... standards.” Similarly, Capek and UBS continued to push the stock, rating it a “strong buy,” and forecasting 2002 and 2003 EPS of \$1.15 and \$1.35, respectively. In a report issued on August 8, 2002, UBS said HealthSouth’s “[b]usiness gains and balance sheet changes bode very well,” that HealthSouth was at the “start of stronger ... income statement ... results,” which “should bolster the share price over the coming quarters.”

43. Then, only three weeks later, on August 27, 2002, Scrushy and other HealthSouth executives caused HealthSouth to announce that it was disavowing its previous earnings forecasts for 2002 and 2003, and that the Company’s annualized earnings would be reduced by approximately \$175 million as a result of Transmittal 1753, which the Company claimed was an unforeseen “change” in the government’s Medicare billing regulations. Investor reaction to HealthSouth’s announcement was swift. HealthSouth shares plunged nearly 60% on August 27-28 to \$5 per share, on extraordinary two-day volume exceeding 84 million shares – compared to its 2002 high of \$15.89 per share near the time Scrushy sold, with UBS’ help, 5.2 million shares at \$14 per share for illegal insider proceeds of \$74 million.

44. After the August 27, 2002 revelations, HealthSouth’s insiders engaged in a final desperate attempt to support HealthSouth’s stock and cover up their prior wrongdoing. In mid-September 2002, Scrushy told analysts and investors he had been subjected to “inaccurate and misleading” reports, “unfounded rumors” and “frivolous lawsuits.” He insisted “the company is in solid financial health.... There is no restatement of earnings here. There is nothing going back ... we have a very profitable company that is extremely strong and has incredible value.” Scrushy assured investors that the suits alleging insider trading by him and other HealthSouth executives – later consolidated into the present Stockholder Class litigation – were “without merit.”

45. However, on September 5, 2002, The Wall Street Journal ran a major story entitled “HealthSouth Corp. Executives Had an Inkling of Problems,” which suggested that, despite his denials, Scrushy had in fact known of Transmittal 1753 and its adverse impact on HealthSouth before he unloaded his HealthSouth stock.

46. Scrushy and his cohorts now knew that they were in big trouble. As part of their effort to cover up their massive fraud, HealthSouth hired a large prestigious national law firm, Fulbright & Jaworski, to conduct an “outside review,” *i.e.*, a purportedly independent investigation, of the insider trading allegations that certain shareholders had made against Scrushy. Scrushy exclaimed, “We have brought in an outstanding law firm and pledged to give them everything they need for a full review.” According to another HealthSouth insider, “When the reviews were completed, it will be shown that we acted properly.... The personal attacks on Richard [Scrushy] are wrong and those making the attacks obviously don’t have the facts .... We have a highly profitable company with operating margins in the mid-20s and all our lines of business are doing well.” When the media questioned the credibility of HealthSouth hiring Fulbright & Jaworski to do the investigation in light of Fulbright & Jaworski’s prior representation of HealthSouth in several of the *qui tam* lawsuits, a HealthSouth spokesperson said “The Company is resting on the integrity and reputation of Fulbright & Jaworski.”

47. However, the Fulbright & Jaworski investigation was never intended to be either independent or thorough – but rather, a cover up that Scrushy and his cohorts hoped would sanitize Scrushy’s illegal insider trading, and put off or avoid a government investigation, enforcement action or even criminal prosecution.

48. To provide sophisticated financial expertise and assistance in its “review,” Fulbright & Jaworski retained FTI Consulting. However, at the outset of the investigation, defendant William T. Owens (“Owens”), HealthSouth’s former CFO and then President and CEO, refused to cooperate

with Fulbright & Jaworski. Nevertheless, during the investigation, Fulbright & Jaworski obtained evidence that, prior to Scrushy's stock sales in May and July 2002, Scrushy was aware that the government was going to issue revised or clarifying Medicare regulations regarding reimbursement for individual versus group treatment that indicated increased focus on the very area where he knew HealthSouth had over-charged Medicare for years, and which would adversely impact HealthSouth's business. Fulbright & Jaworski also found evidence of widespread Medicare billing irregularities by HealthSouth. In addition, Fulbright discovered relevant and damaging evidence shredded by top executives at HealthSouth. And when FTI began to question the accuracy of certain financial representations being made by HealthSouth, HealthSouth arbitrarily shut down this part of the investigation and promptly fired FTI.

49. When Fulbright & Jaworski eventually provided its report to HealthSouth, Scrushy and other HealthSouth insiders quickly crafted a false and misleading public characterization of the investigative report. The initial report mentioned the shredded documents, but mentioning of the shredding was removed at Scrushy's insistence. On October 30, 2002, HealthSouth issued a release headlined "HealthSouth Chairman Richard Scrushy Cleared By Outside Investigation of Advance Knowledge of Medicare Rule Change Prior to Stock Transactions." The release falsely described the investigation as "extensive" and "thorough," and boasted that the review conducted by Fulbright & Jaworski "puts to rest any question whether Mr. Scrushy had any inkling or knowledge of the Medicare reimbursement rule change or its impact prior to his stock transactions in May and July 2002." The release also quoted the report as concluding that Fulbright & Jaworski "has uncovered no oral interview or written document" indicating Scrushy was aware of the Medicare rule change when he sold his stock. In fact, behind the scenes, Fulbright & Jaworski disputed HealthSouth's characterization of its investigation and report as "clearing" Scrushy, and demanded



that HealthSouth publicly retract or correct any such characterization. In the end, HealthSouth terminated Fulbright & Jaworski, too.

50. On November 5, 2002, when HealthSouth reported its results of operations for the third quarter of 2002, Scrushy stressed the “positive things happening,” including “higher revenues in each of our ... lines of business [other than outpatient rehabilitation].” Scrushy proclaimed that he and the HealthSouth Board were “committed ... to continue to build a blue ribbon company and one that shareholders will be proud of and to own the stock.” HealthSouth also stressed that, due to the “incredible investigation” of the Fulbright & Jaworski law firm and its “strong results,” people now “understand that the company has been straight forward.”

51. In early February 2003, Scrushy was interviewed and insisted that “the company is doing extremely well,” “very well in all divisions,” and again condemned the shareholder suits as “frivolous, the stock dropped, you get sued ... many companies in America are going through the same thing. Any time your stock drops, you have these frivolous lawsuits.” According to Scrushy, “this will go away because we haven’t done anything wrong ... we have hired an independent law firm who said that management has done nothing wrong.” As subsequently revealed, these statements by Scrushy were patently false.

52. Indeed, by early February 2003, the DOJ and the Federal Bureau of Investigation (“FBI”) had already commenced a criminal investigation into securities laws violations by Scrushy and other Company executives. On the evening of March 18, 2003, a fraud SWAT team assembled in Birmingham. DOJ and SEC officials flew in from Washington and, together with representatives of the FBI and the Birmingham U.S. Attorney’s office, searched HealthSouth’s corporate office for evidence of accounting and Medicare billing fraud, removing numerous documents and computer files.

53. The next day, March 19, 2003, defendants' scheme further unraveled with the filing of SEC actions against HealthSouth and Scrushy, and the first guilty plea of a HealthSouth officer. Weston Smith, a defendant herein and HealthSouth's then Chief Financial Officer, pled guilty to securities fraud, conspiracy to commit securities fraud and wire fraud, and false certification of financial records. HealthSouth and its shareholders have been devastated by these revelations.

54. Indeed, within weeks of the filing of the SEC actions and the guilty plea by Weston Smith, the following events transpired:

- (a) HealthSouth disavowed its financial statements for the prior years, as audited by E&Y, in light of the SEC Actions and DOJ criminal investigations;

- (b) the New York Stock Exchange suspended trading in HealthSouth stock indefinitely, and the stock collapsed to a low of \$0.10 per share in the over-the-counter pink-sheets;

- (c) Scrushy and other high-level HealthSouth executives were fired, including defendants Owens and Harris;

- (d) E&Y was removed as the Company's outside auditor, and, in an attempt to stave off bankruptcy, a forensic auditing team led by PricewaterhouseCoopers LLP was retained to determine the actual state of HealthSouth's financial condition;

- (e) the turnaround advisory firm, Alvarez & Marsal, Inc., was brought in to help run the day-to-day affairs of the Company;

- (f) Fulbright & Jaworski disclaimed HealthSouth's characterization that its report "cleared" Scrushy, stating that the Company's characterization "may not have been accurate or complete";

- (g) defendants Owens and Harris pled guilty to criminal charges of securities and wire fraud;

(h) the SEC represented that, in connection with its investigation, Scrushy “appears to have testified untruthfully” at a March 14, 2003 deposition, in which he denied instructing HealthSouth employees to change the Company’s financial results;

(i) the Company’s \$1.25 billion line of credit was frozen;

(j) HealthSouth defaulted on the payment of approximately \$354 million in outstanding convertible notes, which were to mature on April 1, 2003; and

(k) Standard & Poor’s (“S&P”) reduced HealthSouth’s credit rating to “D.”

55. More recently, on October 16 and November 5, 2003, the financial collapse of HealthSouth was the subject of hearings before the E&C Committee in which numerous key witnesses were called to testify, including defendant Scrushy (who also invoked the Fifth Amendment privilege against self-incrimination under questioning by the committee); Susan Jones Smith, former HealthSouth Senior VP Finance, Reimbursement (who invoked the Fifth Amendment); other HealthSouth former and current executives and employees possessing direct knowledge of the fraud; representatives from E&Y who directed the purported audits of HealthSouth; and representatives from UBS, including defendants Lorello, McGahan and Capek.

56. On October 29, 2003, defendant Scrushy was indicted on 85 counts of criminal violations including conspiracy and multiple counts of securities fraud, mail fraud, money laundering and false certifications (*United States v. Scrushy*, No. 03-CR- 0530, indictment unsealed, N.D. Ala. Nov. 4, 2003) (“Scrushy Indictment”). Scrushy was arrested by the FBI on November 4, 2003. The charges against Scrushy could result in a maximum total of 650 years in prison and \$36 million in fines.

57. The SARC Report was the result of a 14-month review. The principle objectives of the Committee were to: (a) “[i]dentify misstatements in HealthSouth’s publicly issued financial statements, with emphasis on the period between 1999 and 2001, for which the Company anticipated

restating its annual financial statements, and 2002, for which annual financial statements had yet to be released”; (b) “[q]uantify the impact of those misstatements on the Company’s reported financial results”; and (c) “[o]ffer recommendations with respect to internal controls or other practices designed to prevent the recurrence of financial fraud.”

58. The SARC reported the following notable statements and conclusions: (a) identification of \$2.741 billion in “false or unsupported entries”; (b) identification of \$632 million in other accounting issues and transactions that were “sufficiently aggressive or questionable to warrant discussion”; (c) E&Y had declined to furnish the SARC with access to its workpapers; (d) “nearly 80% of the overstatement of HealthSouth’s pre-tax income” arose from “[i]mproper revenue recognition attributable to reductions of contractual adjustments”; (e) reported cash balances were overstated by approximately \$373 million; (f) the Company’s books carried \$18 million in outstanding loans to employees “despite the absence of timely (or in some cases any) repayment”; (g) “[a]n assessment of whether E&Y fulfilled its responsibilities was beyond the scope of the Committee’s investigation”; and (h) “HealthSouth’s internal controls [continue to] have serious weaknesses, especially in the areas of contractual allowances, receivables, and fixed assets.”

59. The SARC represented that there are “additional accounting issues involving substantial dollar amounts that the Company currently is evaluating,” which include but are not limited to: (a) recognition of impairment of property, plant and equipment, goodwill, and other long-lived assets; (b) the collectibility of, and the determination of appropriate reserves for, accounts receivable; (c) the effect, if any, of restatements on minority interest and incentive compensation calculations; (d) the propriety of consolidation of affiliated entities; (e) tax reporting and accounting for appropriate tax provisions after restatements; and (f) Medicare cost reporting and accounting for settlements and/or retroactive adjustments.

60. Notably, the Committee's work was limited by the refusal of E&Y to grant the Committee access to workpapers for the years 1996 to 2002, and HealthSouth's e-mail retention policy, which resulted in the elimination of most e-mails during the period under investigation.

## **JURISDICTION AND VENUE**

61. Jurisdiction exists pursuant to §22 of the Securities Act, 15 U.S.C. §77v, and §27 of the Exchange Act, 15 U.S.C. §78aa, and 28 U.S.C. §1331. The claims arising from the facts set forth herein and asserted in the accompanying Stockholder and Bondholder complaints arise under §§11, 12(a)(2) and 15 of the Securities Act, 15 U.S.C. §§77k, 77l(a)(2) and 77o, §§10(b), 14(a), 20(a) and 20A of the Exchange Act, 15 U.S.C. §§78j(b), 78n(a), 78t(a), 78t-1 and Rules 10b-5 and 14a-9 promulgated thereunder by the SEC.

62. Venue is proper in this District pursuant to §22 of the Securities Act, and §27 of the Exchange Act and 28 U.S.C. §1391(b). Many of the acts giving rise to the violations complained of occurred in this District. HealthSouth maintains its headquarters in this District.

63. Defendants used the instrumentalities of interstate commerce, including the U.S. mails, and the facilities of the national securities markets.

## **THE PARTIES**

### **Stockholder Plaintiffs**

64. Lead Stockholder Plaintiff Oracle Partners, LP ("Oracle") acquired HealthSouth securities during the Class Period and was damaged thereby, as detailed in the Certification previously submitted to the Court. Oracle was appointed Lead Plaintiff in the Stockholder Litigation by Order dated June 24, 2003.

65. Plaintiff International Union of Operating Engineers, Local 132 Pension Plan ("IUOE") acquired HealthSouth securities during the Class Period and was damaged thereby, as detailed in the Certification attached hereto as Ex. E. IUOE, which is not a Lead Plaintiff in this action, has joined this action as a named plaintiff and proposed Class Representative.

66. Plaintiff Employer-Teamsters Local Nos. 175 & 505 Pension Trust Fund (“Employer-Teamsters”) acquired HealthSouth securities during the Class Period and was damaged thereby, as detailed in the Certification attached hereto as Ex. F. Employer-Teamsters, which is not a Lead Plaintiff in this action, has joined this action as a named plaintiff and proposed Class Representative.

67. Plaintiff Central States, Southeast and Southwest Areas Pension Fund (“Central States”) acquired HealthSouth securities during the Class Period and was damaged thereby, as detailed in the Certification attached hereto as Ex. D. Central States, which is not a Lead Plaintiff in this action, has joined this action as a named plaintiff and proposed Class Representative.

68. Plaintiffs Stephen Kouba and David Dubrow acquired shares of HealthSouth common stock in the merger between HealthSouth and National Surgery Centers, Inc. and were damaged thereby, as detailed in the Certifications previously submitted to the Court. Kouba and Dubrow, who are not Lead Plaintiffs in this action, have joined this action as named plaintiffs and proposed Class Representatives.

69. Plaintiffs Donald Angle, Jack Kennedy and Dale Willetts acquired shares of HealthSouth common stock in the merger between HealthSouth and The Company Doctor and were damaged thereby, as detailed in the Certifications previously submitted to the Court. Angle, Kennedy and Willetts, who are not Lead Plaintiffs in this action, have joined this action as named plaintiffs and proposed Class Representatives.

70. Plaintiffs Franklin and Rosalyn Ross, trustees of the Franklin A. Ross and Rosalyn J. Ross Revocable Living Trust acquired shares of HealthSouth common stock in the merger between HealthSouth and Horizon/CMS Healthcare Corporation and were damaged thereby, as detailed in the Certifications previously submitted to the Court. The Ross’, who are not Lead Plaintiffs in this action, have joined this action as named plaintiffs and proposed Class Representatives.

71. Plaintiff Kenneth Pittman purchased HealthSouth securities during the Stockholder Class Period, contemporaneously with sales of HealthSouth securities by certain defendants, and was damaged thereby, as detailed in the Certification previously submitted to the Court. Pittman, who is not a Lead Plaintiff in this action, has joined this action as a named plaintiff and proposed Class Representative.

72. Plaintiff Julius McQueen purchased HealthSouth securities during the Stockholder Class Period, contemporaneously with sales of HealthSouth securities by certain defendants, and was damaged thereby, as detailed in the Certification previously submitted to the Court. McQueen, who is not a Lead Plaintiff in this action, has joined this action as a named plaintiff and proposed Class Representative.

#### **Bondholder Plaintiffs**

73. Lead Bondholder Plaintiff The Retirement Systems of Alabama (“RSA”) purchased or otherwise acquired during the Bond Class Period, pursuant to an offering memorandum, a registration statement and a prospectus, HealthSouth’s May 2002 Unregistered Notes (as hereinafter defined) and May 2002 Registered Notes (as hereinafter defined) and was damaged thereby, as detailed in the Certification previously submitted to the Court. RSA was appointed Lead Bondholder Plaintiff in the Bondholder Litigation by Order dated June 24, 2003.

74. Plaintiff Houston Firefighters’ Relief and Retirement Fund (“HFF”) purchased or otherwise acquired during the Bond Class Period, pursuant to offering memoranda, registration statements and prospectuses, the following HealthSouth notes and was damaged thereby: HealthSouth’s June 1998 Unregistered Notes (as hereinafter defined) and June 1998 Unregistered Notes (as hereinafter defined), the Company’s February 2001 Registered Notes (as hereinafter defined), and HealthSouth’s May 2002 Unregistered Notes (as hereinafter defined) and May 2002

Registered Notes (as hereinafter defined). HHF, which is not a Lead Plaintiff in this Action, has joined in this action as a Named Plaintiff and proposed Class Representative.

75. Plaintiff State Universities Retirement System of Illinois (“SURS”) was created by Illinois Statute in 1941 to, among other things, manage and invest the funds for employees of the Illinois State Universities System. SURS serves over seventy employers in the State of Illinois, including the state universities, community colleges and state agencies. Its principal offices are in Champaign, Illinois and Chicago, Illinois. SURS currently provides benefit services to over 145,000 members. During the Bond Class Period, SURS purchased, pursuant to offering memoranda, registration statements and prospectuses, HealthSouth’s June 1998 Unregistered Notes (as hereinafter defined) and June 1998 Registered Notes (as hereinafter defined), the Company’s September 2000 Registered Notes (as hereinafter defined), and HealthSouth’s May 2002 Unregistered Notes (as hereinafter defined) and May 2002 Registered Notes (as hereinafter defined), as was damaged thereby. SURS, which is not a Lead Plaintiff in this Action, has joined in this action as a Named Plaintiff and proposed Class Representative.

### **Defendant HealthSouth**

76. Defendant HealthSouth represents that it is the nation’s largest provider of outpatient surgery and rehabilitative healthcare services. It provides such services through its national network of outpatient and inpatient rehabilitation facilities, outpatient surgery centers, diagnostic centers, medical centers and other healthcare facilities. HealthSouth maintains its principal executive offices at One HealthSouth Parkway, Birmingham, Alabama 35243.

### **Senior Officer Defendants**

77. (a) Defendant Scrushy is the founder of HealthSouth and was, at all relevant times, Chairman, Chief Executive Officer (except from August 27, 2002 to January 6, 2003), and a Director of the Company until March 20, 2003, when he was placed on administrative leave. As detailed herein, defendant Scrushy orchestrated the \$2.8 billion financial fraud, was the Company’s



principal spokesman, and made many of the false and misleading statements publicly issued by defendants. Scrushy signed the Registration Statements for all of the Integrated Public Offerings (as defined herein). Additionally, Scrushy financially benefited from the fraud by (i) selling or disposing of more than 11.7 million shares of HealthSouth common stock for proceeds of more than \$207 million; (ii) receiving bonus and employment compensation of at least \$32 million, which was calculated based upon inflated revenues and net income (including bonuses of \$10 million in 1997 and \$6.5 million in 2001); and (iii) selling over 2.5 million shares of the inflated stock to satisfy the \$25 million Loan from the Company. This Loan was made on or about September 10, 1999, as evidenced by a promissory note of the same date, so that Scrushy could purchase HealthSouth stock. Scrushy also benefited by using Company money to finance his lavish lifestyle, including a fleet of jets used in part for personal trips for Scrushy and his family, to finance Scrushy's music bands, and to hire former child star Jason Harvey. As Fortune Magazine noted, "Scrushy certainly enjoyed the trappings of corporate gentry – the four mansions, the ten boats, the \$135,000 bulletproof BMW, the \$7.5 million Sikorsky helicopter, the G-5 jet he sometimes piloted himself."

(b) On October 29, 2003, Scrushy was indicted on 85 counts of criminal conduct associated with the wrongful acts pled in this action.

(c) In addition, Scrushy signed (i) HealthSouth's 1997 Form 10-K, which was filed with the SEC, and was incorporated into the offering memoranda, prospectuses and Registration Statements used by Defendants to effect the March 1998 Integrated Public Offering and the June 1998 Integrated Public Offerings; (ii) HealthSouth's 1998 Form 10-K; (iii) HealthSouth's 1999 Form 10-K, which was filed with the SEC, and was incorporated into the offering memorandum, prospectus and Registration Statement used by Defendants to effect the September 2000 Integrated Public Offering; (iv) HealthSouth's 2000 Form 10-K, which was filed with the SEC, and was incorporated into the offering memoranda, prospectuses and Registration Statements used

by Defendants to effect the February 2001 Integrated Public Offering and the September 2001 Integrated Public Offerings; and (v) HealthSouth's 2001 Form 10-K, which was filed with the SEC, and was incorporated into the purchase agreement, registration rights agreement, offering memorandum, prospectus and Registration Statement used by Defendants to effect the May 2002 Integrated Public Offering. Each of the Forms 10-K contained materially false and misleading statements. Scrushy signed the Registration Statements for the NSC, TCD and Horizon mergers.

(d) Scrushy also signed each of HealthSouth's quarterly reports on Form 10-Q for the period 1997 through and including the second quarter of 2002.

78. (a) Defendant William T. Owens ("Owens") was the President and Chief Operating Officer (except from August 28, 2002 to January 6, 2003, when he was Chief Executive Officer) of HealthSouth from August 2001 through January 2003, Chief Financial Officer from February 2000 through August 2001, and Senior Vice President-Finance and Controller from March 1998 through February 2000. On January 6, 2003, Owens resumed the position of Chief Financial Officer until March 20, 2003, when he and Scrushy were placed on administrative leave. Owens was also a director of the Company between 2001 and October 9, 2003. Owens, a certified public accountant, was on the audit staff of the Birmingham, Alabama office of Ernst & Whinney (now Ernst & Young) from 1982 to 1986, at which time he joined HealthSouth. During the Class Period, Owens sold 226,000 HealthSouth shares for proceeds exceeding \$5.9 million. Owens also was paid a bonus of \$1.5 million in 2001, based in part on HealthSouth's reported net income. Owens signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K and quarterly reports on Form 10-Q for the period 2000 through and including the third quarter of 2002, as well as the Registration Statements for the March 1998 Integrated Public Offering, the June 1998 Integrated Public Offering, the September 2000 Integrated Public Offering, and the February 2001 Integrated Public Offering. On March 25, 2003, Owens pled guilty to charges of securities fraud, conspiracy to commit securities fraud and

wire fraud, knowingly filing false SEC reports and certifications, and criminal forfeiture. On March 31, 2003, the SEC commenced an action against Owens for insider trading and other federal securities law violations. Owens was a spokesman at Company presentations to analysts and investors and a participant in conference calls with investors and analysts during which HealthSouth's inflated financial results were disseminated to the marketplace.

(b) Owens signed the Registration Statements for the March 1998 Integrated Public Offering, the June 1998 Integrated Public Offerings, the September 2000 Integrated Public Offering and the February 2001 Integrated Public Offering. In addition, Owens signed (i) HealthSouth's 1997 Form 10-K, which was filed with the SEC, and was incorporated into the offering memoranda, prospectuses and Registration Statements used by Defendants to effect the March 1998 Integrated Public Offering and the June 1998 Integrated Public Offerings; (ii) HealthSouth's 1999 Form 10-K, which was filed with the SEC, and was incorporated into the offering memorandum, prospectus and Registration Statement used by Defendants to effect the September 2000 Integrated Public Offerings; (iii) HealthSouth's 2000 Form 10-K, which was filed with the SEC, and was incorporated into the offering memoranda, prospectuses and Registration Statements used by Defendants to effect the February 2001 Integrated Public Offering and the September 2001 Integrated Public Offering; and (iv) HealthSouth's 2001 Form 10-K, which was filed with the SEC, and was incorporated into the offering memorandum, prospectus and Registration Statement used by Defendants to effect the May 2002 Integrated Public Offering. Owens also signed the Registration Statements for the NSC, TCD and Horizon mergers.

79. Defendant Weston L. Smith ("Smith") was Executive Vice President and Chief Financial Officer of HealthSouth from August 22, 2001 through August 27, 2002, and Senior Vice President-Finance and Controller from March 2000 through August 2001. Prior thereto, Smith headed the Company's Reimbursement Department. Smith, a certified public accountant, served on

the audit staff of Ernst & Whinney's Birmingham, Alabama office from 1981 through 1986, at which time he joined HealthSouth. Smith signed the Company's 1999, 2000 and 2001 Forms 10-K and the Forms 10-Q for the third quarter of 2001 and the first and second quarters of 2002, as well as the Registration Statements for the September 2000 Integrated Public Offering, the February 2001 Integrated Public Offering, the September 2001 Integrated Public Offerings, and the May 2002 Integrated Public Offering. During the Class Period, Smith sold 92,650 HealthSouth shares for proceeds of over \$1.6 million. On March 19, 2003, Smith pled guilty to four counts of conspiracy to commit securities fraud and wire fraud, knowingly filing false certifications and reports with the SEC, and criminal forfeiture. On March 31, 2003, the SEC commenced an action against Smith for insider trading and other federal securities law violations.

80. Defendant Michael D. Martin ("Martin") was Chief Financial Officer of HealthSouth from October 1997 through February 28, 2000, at which time he became Executive Vice President of Investments. Martin was also a Director between March 1998 and February 2000. In his capacity as CFO, Martin signed the 1997 and 1998 Forms 10-K and numerous Forms 10-Q, as well as the Registration Statements for the March 1998 Integrated Public Offering, June 1998 Integrated Public Offering, the September 2000 Integrated Public Offering, and the NSC and TCD Registration Statements. As detailed herein, as a senior financial executive and a "family member" at HealthSouth, Martin was integrally involved in creating fictitious financial statements which were disseminated to HealthSouth investors and the marketplace. During the Class Period, Martin sold 125,000 HealthSouth shares for proceeds of more than \$3.3 million. On April 8, 2003, Martin pled guilty to charges of securities fraud, conspiracy to commit wire fraud and filing false records.

81. Defendant Aaron Beam, Jr. ("Beam") was a co-founder of HealthSouth. He was Executive Vice President, Chief Financial Officer and a director of HealthSouth until October 1, 1997. Beam continued to be employed by HealthSouth until at least December 31, 1997 to facilitate

the transition to the new CFO. During the Class Period, Beam sold 100,000 HealthSouth shares for proceeds of more than \$2.7 million. On April 24, 2003, Beam pled guilty to charges of bank fraud for making false representations to HealthSouth lenders. Beam signed HealthSouth's Forms 10-Q for the first and second quarters of 1997 as well as the Registration Statement for the Horizon merger.

82. Defendant Anthony J. Tanner ("Tanner") was a co-founder of HealthSouth. Between February 1993 and 1999, Tanner served as Executive Vice President of Administration and a director of HealthSouth, sitting on the Corporate Compliance Committee during 1998-99. During the Class Period, Tanner sold 278,350 HealthSouth shares for proceeds of more than \$7.3 million. Tanner signed the 1997 and 1998 Forms 10-K, and the Registration Statements used in connection with the March 1998 and June 1998 Integrated Public Offerings, and the NSC, TCD and Horizon mergers.

83. Defendant Malcolm E. McVay ("McVay") was, between January 2003 and March 2003, Executive Vice President and Treasurer. Between December 2002 and January 2003, he served as Chief Financial Officer and Treasurer, and from February 2000 through December 2002, as Treasurer. During the Class Period, McVay sold 50,000 shares of HealthSouth common stock for proceeds of \$865,910. McVay signed HealthSouth's Form 10-Q for the third quarter of 2002. On April 21, 2003, McVay pled guilty to charges of conspiracy to commit wire fraud and securities fraud and filing false records.

84. Defendant James P. Bennett ("Bennett") was, between March 1995 and July 2003, the President, Chief Operating Officer and a director of HealthSouth sitting on the Board's Corporate Compliance Committee during 1998-99. Bennett signed the 1997, 1998 and 1999 Forms 10-K. During the Class Period, Bennett sold 199,900 HealthSouth shares for proceeds of more than \$5.2

million. Bennett signed the Registration Statements used in connection with the March 1998 and June 1998 Integrated Public Offerings and for the NSC, TCD and Horizon mergers.

85. Scrushy, Owens, Smith, Beam, McVay, Bennett and Tanner (the “Senior Officer Defendants”) initiated and orchestrated the massive financial fraud and Overbilling and Medicare Frauds which enabled the defendants to enrich themselves by hundreds of millions of dollars while inflicting billions of dollars of damage on purchasers of HealthSouth securities during the Class Period. All of the Senior Officer Defendants (other than Scrushy, Bennett and Tanner), have pled guilty to criminal charges of securities fraud, wire fraud, filing false certifications, and/or criminal forfeiture.

86. The Senior Officer Defendants were the senior most “family members” who directed, discussed and agreed upon the extent and scope of the accounting falsifications that caused the Company’s earnings to be artificially inflated during the Class Period by more than \$2.7 billion through just the financial fraud and caused the price of HealthSouth securities to be artificially inflated. Each of the Senior Officer Defendants had the opportunity to review HealthSouth’s public filings before they were filed with the SEC and the investing public, and were signatories to one or more of HealthSouth’s reports on Form 10-K and/or Form 10-Q filed with the SEC during the Class Period, all of which contained materially false and misleading information concerning HealthSouth’s revenues, net income, assets and EPS.

87. In addition, during the Class Period the Senior Officer Defendants acted as spokesmen at Company presentations to analysts and investors, and/or participated in conference calls with analysts and investors in which materially false and misleading statements concerning HealthSouth’s financial results and operations were publicly disseminated.

88. The Senior Officer Defendants also engaged in massive illegal insider trading of HealthSouth’s common stock during the Class Period while in the possession of material adverse

information concerning the Company, reaping illegal insider trading proceeds in excess of \$234 million.

### **Employee Defendants**

89. Defendant Robert E. Thomson (“Thomson”) was, between February 1996 and 2001, President and Chief Operating Officer of HealthSouth’s Inpatient Division. During the Class Period, Thomson sold 263,500 HealthSouth shares for proceeds of more than \$5.8 million.

90. Defendant Thomas W. Carman (“Carman”) was, between June 1992 and 2001, Executive Vice President, Corporate Development. From 2001 to the present, Carman has been the Executive Vice President of Mergers and Acquisitions. During the Class Period, Carman sold 485,000 HealthSouth shares for proceeds of more than \$10.1 million.

91. Defendant P. Daryl Brown (“D. Brown”) was, between June 1992 and September 1999, President and Chief Operating Officer of HealthSouth’s Outpatient Division and a director of HealthSouth between March 1995 and May 2000. During the Class Period, D. Brown sold 179,810 HealthSouth shares for proceeds of more than \$4.8 million. D. Brown signed the Registration Statements used in connection with the March 1998 and June 1998 Integrated Public Offerings, and the NSC, TCD and Horizon mergers, and the 1997, 1998 and 1999 Forms 10-K.

92. Defendant Patrick A. Foster (“Foster”) was, between October 1997 and September 1999, President and Chief Operating Officer of HealthSouth’s Surgery Division. During the Class Period, Foster sold 381,337 HealthSouth shares for proceeds of \$6.6 million.

93. Defendant Emery W. Harris (“Harris”) held various positions in HealthSouth’s Accounting Department between 1992 and March 2000. Between March 2000 and March 2003, he was Group Vice President of Accounting and Assistant Controller. On March 31, 2003, Harris pled guilty to charges of conspiracy to commit wire fraud and securities fraud and filing false records.

On December 15, 2003, Harris was sentenced to five months in prison, three years probation, fined \$3,000 and ordered to forfeit \$106,500 in HealthSouth salary and bonuses.

94. Defendant Angela Ayers (“Ayers”) was, between 1994 and 2002, Accounting Manager and Director of Accounting. From 2002 to March of 2003, Ayers was Assistant Vice President of the Accounting Department. On April 3, 2003, Ayers pled guilty to conspiracy to commit wire fraud, securities fraud and making false books and records. On December 15, 2003, Ayers was sentenced to four years probation, with six months unsupervised home confinement and payment of a \$2,000 fine.

95. Defendant Kenneth Livesay (“Livesay”) was, between 1989 and 1992, Assistant Vice President of Finance and Assistant Controller. Between 1992 and 1999, Livesay was Vice President of Finance and Assistant Controller, and from 1999 to April 3, 2003, he was Chief Information Officer. On April 3, 2003, Livesay pled guilty to charges of falsifying financial information and conspiracy to commit wire fraud and securities fraud.

96. Defendant Cathy C. Edwards (“Edwards”) worked in HealthSouth’s Accounting Department between 1993 and 1999. Between 1999 and April 3, 2003, Edwards was a Vice President of Accounting. On April 3, 2003, Edwards pled guilty to conspiracy to commit wire fraud, securities fraud and making false books and records. On December 15, 2003, Edwards was sentenced to four years probation, with six months unsupervised home confinement and payment of a \$2,000 fine.

97. Defendant Rebecca Kay Morgan (“Morgan”) worked in HealthSouth’s Accounting Department between 1987 and 1999. Between 1999 and April 3, 2003, Morgan was Group Vice President in Accounting. On April 3, 2003, Morgan pled guilty to conspiracy to commit wire fraud, securities fraud and making false books and records. On December 15, 2003, Morgan was sentenced



to four years probation, with six months unsupervised home confinement and payment of a \$2,000 fine.

98. Defendant Virginia B. Valentine (“Valentine”) worked in HealthSouth’s Accounting Department between 1995 and 2000. Between 2000 and April 3, 2003, Valentine was Assistant Vice President, Accounting. On April 3, 2003, Valentine pled guilty to conspiracy to commit wire fraud, securities fraud and making false books and records. On December 15, 2003, Valentine was sentenced to four years probation with six months unsupervised home confinement and payment of a \$2,000 fine.

99. Defendant Richard E. Botts (“Botts”) was, between May 1998 and July 2003, Senior Vice President for the Tax Department. On July 31, 2003, Botts pled guilty to charges of conspiracy to commit securities fraud, falsifying books and mail fraud.

100. Defendant Will Hicks (“Hicks”) was, between March 1999 and July 2003, Vice President of Investments. On July 3, 2003, Hicks pled guilty to charges of conspiracy to make false statements to auditors and maintaining false business records.

101. Defendant Jason M. Brown (“J. Brown”) held various positions while at HealthSouth. Between 1994 and mid-1996, he was in the Accounting Division. Between mid-1996 and December 1997, he was with the Corporate Development Department. Between December 1997 and May 2000, he was with the Treasury Department, and between May 2000 and July 2003, was Vice President of Finance. On July 8, 2003, J. Brown pled guilty to charges of conspiracy to commit securities fraud, falsifying books and records and wire fraud.

102. Defendant Brandon O. Hale (“Hale”) joined HealthSouth in July 1986 as Director of Human Services and became Vice President of Human Resources and Group Vice President, Human Resources. Since December 1999, Hale has served as HealthSouth’s Senior Vice President-

Administration and Secretary. Hale also served as Corporate Compliance Officer. During the Class Period, Hale sold 42,200 HealthSouth shares for proceeds of more than \$650,972.

103. Defendant Russell H. Maddox (“Maddox”) was President of HealthSouth’s Imaging Center. During the Class Period, Maddox attended or gave presentations at meetings of HealthSouth’s Board of Directors as more fully set forth in Appendix 5.

104. Defendant Larry D. Taylor (“Taylor”) was President of HealthSouth Ambulatory Services – East. During the Class Period, Taylor attended or gave presentations at meetings of HealthSouth’s Board of Directors as more fully set forth in Appendix 5.

105. Defendant Susan M. Jones (“S. Jones”) a/k/a Susan Jones-Smith, is a C.P.A. who joined HealthSouth in November 1989 and served as Assistant Vice President of Finance – Reimbursement from February 1992 to February 1995. In February 1995, Jones was promoted to Vice President Finance – Reimbursement, and in March 2000 became Senior Vice President – Reimbursement. Before joining HealthSouth, Jones was a C.P.A. in the Birmingham office of Ernst & Whinney. During the Class Period, Jones sold 28,750 HealthSouth shares for proceeds of \$498,114. Jones is married to defendant Smith. S. Jones is one of only three former HealthSouth executives (including Scrushy) identified by the SARC as having declined to speak with the SARC.

106. Defendant William W. Horton (“Horton”) joined HealthSouth in 1994 as Group Vice President-Legal Services, was named Senior Vice President and Corporate Counsel in May 1996, and later served as Executive Vice President and Corporate Counsel between March 2001 and September 2003. Horton sold 125,000 shares of his HealthSouth stock during the Class Period for proceeds of over \$2.2 million.

107. Defendant Catherine Fowler (“Fowler”) was a former cash manager and Vice President in HealthSouth’s Treasury Department. On November 24, 2003, Fowler pled guilty to

charges of conspiracy to commit wire fraud, securities fraud and making false entries in book and records and false certification of financial information filed with the SEC.

108. Thomson, Carman, Foster, J. Brown, Martin, Hale, Horton, Fowler, Harris, Livesay, Ayers, Edwards, Morgan, Valentine, Botts, Hicks, D. Brown, Maddox, Taylor and S. Jones (the “Employee Defendants”) were key participants in the perpetration of the financial fraud which caused the Company’s earnings to be artificially inflated by more than \$2.7 billion and caused the price of HealthSouth’s securities to be artificially inflated during the Class Period, all to the detriment of plaintiffs and the investing public.

109. Additionally, Harris, Livesay, Ayers, Edwards, Morgan, Valentine, Botts, Hicks, S. Jones and D. Brown were “family” members, who, in concert with the Senior Officer Defendants, discussed and agreed upon the extent and scope of the accounting falsifications which caused the Company’s earnings to be artificially inflated during the Class Period by more than \$2.7 billion through just the financial fraud and caused the price of HealthSouth securities to be artificially inflated.

110. Each of the Employee Defendants thus participated directly in the ongoing and pervasive conspiracy to artificially inflate the earnings of HealthSouth throughout the Class Period.

#### **Director Defendants**

111. Defendant Larry R. House (“House”) was, between February 1993 and 1998, a director of HealthSouth. House signed the 1997 Form 10-K and the Registration Statement for the Horizon merger. During the Class Period, House sold 482,996 shares of HealthSouth common stock, representing 100% of the HealthSouth stock owned by him, for proceeds of more than \$13 million.

112. Defendant Richard F. Celeste (“Celeste”) was, between May 1995 and 1997, a director of HealthSouth. Celeste signed the Registration Statement for the Horizon merger. During the Class Period, Celeste sold 60,000 HealthSouth shares for proceeds of more than \$1.6 million.

113. Defendant C. Sage Givens (“Givens”) is currently a director of HealthSouth. Givens has held this position since 1985. Between 1985 and 1995, Givens was Vice President of First Century Partners, a venture capital arm of defendant Citi/Salomon, which made a substantial profit on its investment in HealthSouth. By 1995, Givens founded her own healthcare services venture capital fund, Acacia Venture Partners, in which HealthSouth was among the first to invest, contributing \$1.3 million to the \$80 million fund. Three years later, Acacia started a \$120 million fund, with a \$2.2 million contribution from HealthSouth. In 1998, Acacia paid \$1.8 million for its portion of HealthSouth’s physician staffing business. Later, Acacia invested \$25,000 in Medcenterdirect, an electronic commerce site for hospital products in which HealthSouth was a primary investor. Givens sat on the Board’s Audit/Compensation Committee between 1995 and March 2000 on the Audit Committee between March 2000 and 2002 and the Nominating Committee between 2001 and 2002.<sup>6</sup> During the Class Period, Givens sold 240,000 HealthSouth shares for proceeds of more than \$4.29 million. Givens signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K. Givens also signed the Registration Statements used in connection with the following HealthSouth Integrated Public Offerings: March 1998, June 1998, September 2000, February 2001, September 2001 and May 2002 as well as the NSC, TCD and Horizon mergers.

114. Defendant George H. Strong (“Strong”) was a director of HealthSouth from 1984 to December 2003. Strong sat on the Board’s Audit/Compensation Committee between 1995 and

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<sup>6</sup> Prior to March 2000, the Audit and Compensation Committee was a joint committee. As of March 2000, they operated separately. The Audit Committee, as was stated in HealthSouth’s 1999, 2000 and 2001 Proxy Statements, pursuant to §14A of the Exchange Act was responsible for “reviewing all reports from [HealthSouth’s] auditors and monitoring internal controls.”

March 2000 on the Audit Committee between March 2000 and 2002 and on the Nominating Committee between 2001 and 2002. During the Class Period, Strong sold 115,866 HealthSouth shares for proceeds of more than \$1.53 million. Strong signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K. Strong also signed the Registration Statements used in connection with the following HealthSouth Integrated Public Offerings: March 1998, June 1998, September 2000, February 2001, September 2001 and May 2002 as well as the NSC, TCD and Horizon mergers.

115. Defendant Larry D. Striplin, Jr. (“Striplin”) is currently a director of HealthSouth. Striplin has held this position since April 1999. Striplin sat on the Board’s Audit Committee between March 2000 and 2002 and on the Compensation Committee between March 2000 and 2002. Striplin signed the 1998, 1999, 2000 and 2001 Forms 10-K. Striplin also signed the Registration Statements used in connection with the September 2000, February 2001, September 2001, and May 2002 Integrated Public Offerings.

116. Defendant Joel C. Gordon (“Gordon”) is currently the Interim Chairman of the Board, and a director of HealthSouth. Gordon has been a Director since 1996 and sat on the Board’s Corporate Compliance Committee during 2002, and on Special Litigation Committee during 2002. Gordon signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K. Gordon also signed the Registration Statements used in connection with the following HealthSouth Integrated Public Offerings: March 1998, June 1998, September 2000, February 2001, September 2001, and May 2002 as well as the NSC, TCD and Horizon mergers.

117. Defendant John S. Chamberlin (“Chamberlin”) is currently a director of HealthSouth and has held that position since 1993. Chamberlin sat on the Board’s Corporate Compliance Committee between 1998 and 1999 and on the Compensation Committee between 2000 and 2002. Chamberlin signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K. Chamberlin also signed the Registration Statements used in connection with the following HealthSouth Integrated Public

Offerings: March 1998, June 1998, September 2000, February 2001, September 2001 and May 2002 as well as the NSC, TCD and Horizon mergers.

118. Defendant Jan L. Jones (“J. Jones”) was a director of HealthSouth and a member of the Board’s Compensation Committee between 2000 and February 2001. Jones signed the 1999 Form 10-K and the Registration Statement used in connection with HealthSouth’s September 2000 Integrated Public Offering.

119. Defendant Charles W. Newhall III (“Newhall”) was a director of HealthSouth from 1985 until December 2003. Newhall sat on the Board’s Independent Stock Committee during 1995, on the Corporate Compliance Committee between 1998 and 2002 and on the Nominating Committee during 2001 and 2002. During the Class Period, Newhall sold 1,673,781 shares of the HealthSouth stock for proceeds exceeding \$14.4 million. Newhall signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K. Newhall also signed the Registration Statements used in connection with the following HealthSouth Integrated Public Offerings: March 1998, June 1998, September 2000, September 2001 and May 2002 as well as the NSC, TCD and Horizon mergers.

120. Defendant Edwin M. Crawford (“Crawford”) was a director of HealthSouth between 1998 and 1999. Crawford signed the Registration Statement for HealthSouth’s June 1998 Integrated Public Offering as well as for the NSC mergers.

121. Defendant Phillip C. Watkins (“Watkins”) was, between 1984 and February 2003, a director of HealthSouth. Watkins sat on the Board’s Audit/Compensation Committee (the Audit Committee, as was stated in HealthSouth’s 1999, 2000 and 2001 Proxy Statements pursuant to §14A of the Exchange Act, was responsible for “reviewing all reports from [HealthSouth’s] auditors and monitoring internal controls”) between 1995 and March 2000, on the Corporate Compliance Committee between 2000 and 2002 and on the Compensation Committee during 2001. During the Class Period, Watkins sold 210,000 HealthSouth shares for proceeds of more than \$4.9 million.

Watkins signed the 1997, 1998, 1999, 2000 and 2001 Forms 10-K. Watkins also signed the Registration Statements used in connection with the following Integrated Public Offerings: March 1998, June 1998, September 2000, February 2001, September 2001 and May 2002 as well as the NSC, TCD and Horizon mergers.

122. As directors of HealthSouth during the Class Period, House, Watkins, Celeste, Givens, Strong, Striplin, Gordon, Chamberlain, J. Jones, Crawford and Newhall (the “Director Defendants”) had access to the books and records of HealthSouth, acquired extensive knowledge of the affairs of HealthSouth, and had the ability to control the business and corporate affairs of the Company. Indeed, each of the Director Defendants was charged with the duty to: (a) ensure that the Company was operated in a diligent, honest and prudent manner and complied with all applicable federal and state laws, rules, regulations and requirements, including acting only within the scope of its legal authority and disseminating truthful and accurate statements to the SEC and the investing public; (b) ensure that the Company’s financial statements were prepared in accordance with Generally Accepted Accounting Principles (“GAAP”); and (c) refrain from acting upon material inside corporate information to benefit themselves at the expense of the public shareholders of HealthSouth.

123. Each of the Director Defendants had the opportunity to review HealthSouth’s public filings before they were filed with the SEC and distributed to plaintiffs and the investing public, and were signatories to one or more of HealthSouth’s Reports on Form 10-K filed with the SEC during the Class Period, all of which contained materially false and misleading information concerning HealthSouth’s revenues, net income, assets and EPS.

124. In addition, the Director Defendants, and particularly Watkins, Givens, Strong and Striplin, who served as members of HealthSouth’s Audit Committee, were privy to the financial and accounting records of HealthSouth, responsible for maintaining and establishing adequate internal

accounting controls for HealthSouth, and responsible for ensuring that the Company's financial statements were based on accurate financial information and prepared in accordance with GAAP.

125. As a result, the Director Defendants knew or were reckless in not knowing the facts underlying this massive accounting and Medicare fraud which resulted through just the financial fraud, in more than \$2.7 billion in false earnings being reported by HealthSouth during the Class Period.

### **Defendant Ernst & Young**

126. (a) Defendant E&Y is an international accounting and consulting firm. E&Y was engaged by HealthSouth to provide "independent" public auditing, accounting and management consulting services, tax services, examination and review of filings with the SEC, audits and/or reviews of financial statements which were included in HealthSouth's SEC filings, including audited and unaudited information, and annual reports. E&Y was HealthSouth's auditor from 1986 until early 2003. As a result of the myriad of services it rendered to HealthSouth, E&Y personnel were present at HealthSouth corporate offices and operations continuously during the Class Period, and had continual access to, and knowledge of, HealthSouth's private and confidential corporate information and business information. HealthSouth has now admitted that its financial statements were misstated by \$2.7 billion during 1997-2002, the same years for which E&Y issued unqualified "clean" auditor's reports on HealthSouth's financial statements. E&Y also participated in HealthSouth's "Pristine Audits," and advised the Company to misclassify the fees for this non-audit service as "Audit-Related Fees" in public filings.

(b) During the time E&Y was HealthSouth's independent public accountant, E&Y audited all of the annual consolidated financial statements HealthSouth issued and filed with the SEC. As relevant to the claims asserted herein, E&Y audited the Company's consolidated financial statements as of, and for the years ended, December 31, 1997, 1998, 1999, 2000 and 2001,



all of which were filed with the SEC on Forms 10-K. In connection with those audits, E&Y issued its unqualified auditor's reports dated February 24, 1997 (the "1996 Audit Report"); February 25, 1998 (except as for Note 14, as to which the date was March 20, 1998) (the "1997 Audit Report"); March 19, 1999 (the "1998 Audit Report"); March 19, 2000 (the "1999 Audit Report"); March 6, 2001 (the "2000 Audit Report"); and March 12, 2002 (the "2001 Audit report"), respectively. In each of those unqualified auditor's reports, E&Y certified (i) that it had audited HealthSouth's financial statements "in accordance with [GAAS]"; (ii) that it had planned and performed those audits "to obtain reasonable assurance about whether the financial statements are free of material misstatement"; (iii) that, in its opinion, HealthSouth's financial statements "present fairly, in all material respects, the consolidated financial position of HEALTHSOUTH Corporation and Subsidiaries ..., and the consolidated results of their operations and their cash flows" each "in conformity with [GAAP]"; and (iv) that its audits provided a "reasonable basis" for its opinions.

(c) Each of the Registration Statements, included as Exhibit 23.1 thereto, the "Consent of Ernst & Young LLP Independent Auditors," in which E&Y consented to the reference to E&Y under the caption "Experts" in each such Registration Statement, and to the incorporation by reference of E&Y's unqualified auditor's reports, as described above, as follows:

(i) the 1996 Audit Report was incorporated into the Horizon Registration Statement by consent dated September 18, 1997;

(ii) the 1997 Audit Report was incorporated into the March Registration Statement by consent dated June 1, 1998, into the June 1998 Registration Statement by consent dated September 9, 1998, into the NSC Registration Statement by consent dated June 16, 1998, and into the TCD Registration Statement by consent dated May 14, 1998;

(iii) the 1999 Audit Report was incorporated into the September 2000 Registration Statement by consent dated December 11, 2000;

(iv) the 2000 Audit Report was incorporated into the February 2001 Registration Statement by consent dated March 23, 2001, and into the September 2001 Registration Statement by consent dated November 13, 2001; and

(v) the 2001 Audit Report was incorporated into the May 2002 Registration Statement by consent dated August 19, 2002.

(d) Accordingly, as set forth under the caption “Experts” in the Registration Statements, the HealthSouth consolidated financial statements as of, and for the years ended, December 31, 1997, 1998, 1999, 2000 and 2001 were included “in reliance upon” E&Y’s unqualified audit report, “given upon the authority of [E&Y] as experts in accounting and auditing.”

(e) E&Y’s role in the fraud alleged herein.

#### **Underwriter Defendants**

127. Defendant UBS AG (referred to as “UBS”) is a large integrated financial services institution that through subsidiaries and divisions provides commercial and investment banking services, commercial loans to corporate entities, and advisory services regarding the structuring of financial transactions, including engaging in, or helping to structure derivatives and hedging financial transactions, acting as underwriter in the sale of corporate securities to the public and providing investment analysis and opinions on public companies, including its clients, via reports issued by securities analysts. As detailed herein, UBS is liable as the successor entity for the actions of (a) Warburg Dillon Read, which was merged with UBS Securities in 1998 and was renamed UBS Warburg, LLC, and (b) PaineWebber Group, Inc., with which subsidiary UBS Americas, Inc. merged in 2000 and now does business as UBS Financial Services, Inc. UBS engaged and participated in the scheme to defraud purchasers of HealthSouth securities by rendering all of the above services to HealthSouth, as described in this Complaint. UBS is also liable under the

Securities Act in connection with HealthSouth securities offerings. UBS subsequently sold the majority, if not all, of these debt securities to Qualified Institutional Investors (“QIBs”).

(a) Defendant UBS Warburg, LLC (“UBS Warburg”), an entity principally owned by UBS AG, was the lead underwriter of the following HealthSouth Integrated Public Offerings: the September 2000 Integrated Public Offering, the February 2001 Integrated Public Offering, the September 2001 Integrated Public Offerings, and the May 2002 Integrated Public Offering. In the September 2000 Integrated Public Offering, UBS Warburg purchased \$148,750,000 of the September 2000 Unregistered Notes; in the February 2001 Integrated Public Offering, UBS Warburg purchased \$187,500,000 of HealthSouth’s Unregistered Notes; in the September 2001 Integrated Public Offerings, UBS Warburg purchased a total of \$275,000,000 of HealthSouth’s September 2001 Unregistered Notes; and in the May 2002 Integrated Public Offering, UBS Warburg purchased \$200,045,139 of HealthSouth’s May 2002 Unregistered Notes.

(b) Defendant PaineWebber, Incorporated (“PaineWebber”), now d/b/a UBS Financial Services, Inc., a subsidiary of UBS AG, was an underwriter of HealthSouth’s March 1998 Integrated Public Offering and its June 1998 Integrated Public Offerings. In the March 1998 Integrated Public Offering, PaineWebber purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes; in the June 1998 Integrated Public Offerings, PaineWebber purchased a total of \$22,500,000 of HealthSouth’s June 1998 Unregistered Notes.

(c) As noted above, PaineWebber subsequently sold the majority, if not all, of these debt securities to QIBs.

128. Defendant Citigroup, Inc. (referred to as “Citi/Salomon”) is a large integrated financial services institution that through subsidiaries and divisions provides commercial and investment banking services, commercial loans to corporate entities, and advisory services regarding the structuring of financial transactions, including engaging in or helping to structure, derivative and

hedging financial transactions, acting as underwriter in the sale of corporate securities to the public and providing investment analysis and opinions on public companies, including its clients, via reports issued by securities analysts. As detailed herein, Citi/Salomon is liable as the parent entity for the actions of Smith Barney, which is a division of Citi/Salomon, and for Salomon Brothers and Salomon Smith Barney, both of which now do business as Citigroup Global Markets. Citi/Salomon engaged and participated in the scheme to defraud purchasers of HealthSouth securities by rendering all of the above services to HealthSouth as described in detail in this Complaint. Citi/Salomon is also liable under the Securities Act in connection with HealthSouth securities offerings.

(a) Defendant Smith Barney, Inc. (“Smith Barney”), now a subsidiary of defendant Citigroup, a division of Citigroup Global Markets, was the lead underwriter for HealthSouth’s March 1998 Integrated Public Offering, in which Smith Barney purchased \$459,750,000 of HealthSouth’s unregistered 3¼% Convertible Subordinate Debentures due 2002. Smith Barney subsequently sold the majority, if not all, of these debt securities to Qualified Institutional Buyers (“QIBs”).

(b) Defendant Salomon Brothers, Inc. (“Salomon Brothers”), now d/b/a Citigroup Global Markets, a subsidiary of defendant Citigroup, was the lead underwriter for HealthSouth’s June 1998 Integrated Public Offerings in which Salomon Brothers purchased a total of \$150,000,000 of HealthSouth’s June 1998 Unregistered Notes. Salomon Brothers subsequently sold the majority, if not all, of these debt securities to QIBs.

(c) Defendant Salomon Smith Barney (“Salomon Smith Barney”), now d/b/a Citigroup Global Markets, a subsidiary of defendant Citigroup, was an underwriter of HealthSouth’s May 2002 Integrated Public Offering, in which it purchased \$20,517,450 of HealthSouth’s unregistered 7⅝% Senior Notes due 2012. Salomon Smith Barney subsequently sold the majority, if

not all, of these debt securities to QIBs. (Together, defendants Smith Barney, Salomon Brothers and Salomon Smith Barney shall be referred to as the “Citi/Salomon Underwriters.”)

#### **Additional Underwriter Defendants**

129. Citi/Salomon, UBS and the financial institutions described below in sub-paragraphs (a) through (s) (collectively, the “Underwriter Defendants”) are financial services institutions that, through their respective subsidiaries and divisions, provided and continue to provide, commercial and investment banking services, as well as commercial loans, to their corporate clients:

(a) Defendant J.P. Morgan Securities, Inc. (“J.P. Morgan Securities”), a subsidiary of J.P. Morgan Chase & Co., was an underwriter of the following HealthSouth Integrated Public Offerings: the March 1998 Integrated Public Offering, the June 1998 Integrated Public Offerings, the September 2001 Integrated Public Offerings, and the May 2002 Integrated Public Offering. In the March 1998 Integrated Public Offering, J.P. Morgan purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes; in the June 1998 Integrated Public Offering, J.P. Morgan purchased a total of \$47,500,000 of HealthSouth’s June 1998 Unregistered Notes; in the September 2001 Integrated Public Offerings, J.P. Morgan purchased a total of \$72,500,000 of HealthSouth’s September 2001 Unregistered Notes; and in the May 2002 Integrated Public Offering, J.P. Morgan purchased \$88,225,035 of HealthSouth’s May 2002 Unregistered Notes. J.P. Morgan subsequently sold the majority, if not all, of these debt securities to QIBs.

(b) Defendant Chase Securities, Inc. (“Chase”), now d/b/a J.P. Morgan Securities, a subsidiary of J.P. Morgan Chase & Co., was an underwriter of HealthSouth’s September 2000 Integrated Public Offering, and its February 2001 Integrated Public Offering. In the September 2000 Integrated Public Offering, Chase Securities purchased \$70,000,000 of HealthSouth’s September 2000 Unregistered Notes; in the February 2001 Integrated Public Offering, Chase purchased \$65,625,000 of HealthSouth’s February 2001 Unregistered Notes. Chase subsequently sold the

majority, if not all, of these debt securities to QIBs. (Together, defendants J.P. Morgan Securities and Chase shall be referred to as the “J.P. Morgan Chase Underwriters.”)

(c) Defendant Bear Stearns & Co. (“Bear Stearns”), Inc. was an underwriter of HealthSouth’s March 1998 Integrated Public Offering and its June 1998 Integrated Public Offerings. In the March 1998 Integrated Public Offering, Bear Stearns purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes; in the June 1998 Integrated Public Offering, Bear Stearns purchased a total of \$11,250,000 of HealthSouth’s June 1998 Unregistered Notes. Bear Stearns subsequently sold the majority, if not all, of these debt securities to QIBs.

(d) Defendant Cowen & Company (“Cowen”), now d/b/a SG Cowen Securities Corporation, was an underwriter in HealthSouth’s March 1998 Integrated Public Offering in which Cowen purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes. Cowen subsequently sold the majority, if not all, of these debt securities to QIBs.

(e) Defendant Credit Suisse First Boston Corporation (“CSFB”) was an underwriter of HealthSouth’s March 1998 Integrated Public Offering and its June 1998 Integrated Public Offerings. In the March 1998 Integrated Public Offering, CSFB purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes; in the June 1998 Integrated Public Offering, CSFB purchased a total of \$22,500,000 of HealthSouth’s June 1998 Unregistered Notes. CSFB subsequently sold the majority, if not all, of these debt securities to QIBs.

(f) Defendant Morgan Stanley & Co. (“Morgan Stanley”) was an underwriter of HealthSouth’s March 1998 Integrated Public Offering and its June 1998 Integrated Public Offerings. In the March 1998 Integrated Public Offering, Morgan Stanley purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes; in the June 1998 Integrated Public Offerings, Morgan Stanley purchased a total of \$47,500,000 of HealthSouth’s June 1998 Unregistered Notes. Morgan Stanley subsequently sold the majority, if not all, of these debt securities to QIBs.

(g) Defendant Goldman, Sachs & Co. (“Goldman”), was an underwriter of HealthSouth’s June 1998 Integrated Public Offerings in which Goldman purchased \$47,500,000 of HealthSouth’s June 1998 Unregistered Notes. Goldman subsequently sold the majority, if not all, of these debt securities to QIBs.

(h) Defendant Merrill Lynch, Pierce, Fenner & Smith, Incorporated (“Merrill Lynch”), a subsidiary of Merrill Lynch & Co., Inc., was an underwriter of HealthSouth’s June 1998 Integrated Public Offerings in which Merrill Lynch purchased a total of \$47,500,000 of HealthSouth’s June 1998 Unregistered Notes. Merrill Lynch subsequently sold the majority, if not all, of these debt securities to QIBs.

(i) Defendant Deutsche Bank Securities, Inc. (“Deutsche Bank”), a subsidiary of Deutsche Bank AG, was an underwriter of HealthSouth’s September 2000 Integrated Public Offering and its May 2002 Integrated Public Offering. In the September 2000 Integrated Public Offering, Deutsche Bank purchased \$113,750,000 of HealthSouth’s September 2000 Unregistered Notes; in the May 2002 Integrated Public Offering, Deutsche Bank purchased \$200,045,138 of HealthSouth’s May 2002 Unregistered Notes. Deutsche Bank subsequently sold the majority, if not all, of these debt securities to QIBs.

(j) Deutsche Bank Alex. Brown, Inc. (“Deutsche Bank Alex. Brown”), a division of Deutsche Bank Securities, Inc., a subsidiary of Deutsche Bank AG, was an underwriter of HealthSouth’s February 2001 Integrated Public Offering and its September 2001 Integrated Public Offerings. In the February 2001 Integrated Public Offering, Deutsche Bank Alex. Brown purchased \$84,375,000 of HealthSouth’s February 2001 Unregistered Notes. In the September 2001 Integrated Public Offering, Deutsche Bank Alex. Brown purchased a total of \$100,000,000 of HealthSouth’s September 2001 Unregistered Notes. Deutsche Bank Alex. Brown subsequently sold the majority, if not all, of these debt securities to QIBs.

(k) Defendant First Union Securities, Inc. (“First Union”), now d/b/a Wachovia Securities, Inc., was an underwriter of the following HealthSouth Integrated Public Offerings: the September 2000 Integrated Public Offering, the February 2001 Integrated Public Offering, the September 2001 Integrated Public Offerings, and the May 2002 Integrated Public Offering. In the September 2000 Integrated Public Offering, First Union purchased \$17,500,000 of HealthSouth’s September 2000 Unregistered Notes; in the February 2001 Integrated Public Offering, First Union purchased \$18,750,000 of HealthSouth’s February 2001 Unregistered Notes; in the September 2001 Integrated Public Offerings, First Union purchased a total of \$72,500,000 of HealthSouth’s September 2001 Unregistered Notes; in the May 2002 Integrated Public Offering, First Union purchased \$119,001,211 of HealthSouth’s May 2002 Unregistered Notes. First Union subsequently sold the majority, if not all, of these debt securities to QIBs.

(l) Defendant Scotia Capital Markets (USA), Inc. (“Scotia Capital”), a division of Scotia Capital Inc., was an underwriter of HealthSouth’s February 2001 Integrated Public Offering and its September 2001 Integrated Public Offerings. In the February 2001 Integrated Public Offering, Scotia Capital purchased \$18,750,000 of HealthSouth’s February 2001 Unregistered Notes; in the September 2001 Integrated Public Offering, Scotia Capital purchased a total of \$153,880,876 of HealthSouth’s September 2001 Unregistered Notes. Scotia Capital subsequently sold the majority, if not all, of these debt securities to QIBs.

(m) Defendant Jefferies & Company, Inc. (“Jefferies”) was an underwriter of HealthSouth’s September 2001 Integrated Public Offerings and its May 2002 Integrated Public Offering. In the September 2001 Integrated Public Offerings, Jefferies purchased a total of \$11,250,000 of HealthSouth’s September 2001 Unregistered Notes; in the May 2002 Integrated Public Offering, Jefferies purchased \$12,310,470 of HealthSouth’s May 2002 Unregistered Notes. Jefferies subsequently sold the majority, if not all, of these debt securities to QIBs.



(n) Defendant Lehman Brothers, Inc. (“Lehman Brothers”) was an underwriter of HealthSouth’s September 2001 Integrated Public Offerings in which Lehman Brothers purchased a total of \$25,000,000 of HealthSouth’s September 2001 Unregistered Notes. Lehman Brothers subsequently sold the majority, if not all, of these debt securities to QIBs.

(o) Defendant BNY Capital Markets, Inc. (“BNY”) was an underwriter of HealthSouth’s September 2001 Integrated Public Offerings in which BNY purchased a total of \$25,000,000 of HealthSouth’s September 2001 Unregistered Notes. BNY subsequently sold the majority, if not all, of these debt securities to QIBs.

(p) Defendant Fleet Securities, Inc. (“Fleet”), a wholly owned subsidiary of FleetBoston Financial Corp., was an underwriter of HealthSouth’s September 2001 Integrated Public Offerings, and of its May 2002 Integrated Public Offering. In the September 2001 Integrated Public Offerings, Fleet purchased a total of \$6,250,000 of HealthSouth’s September 2001 Unregistered Notes; in the May 2002 Integrated Public Offering, Fleet purchased \$33,340,856 of HealthSouth’s May 2002 Unregistered Notes. Fleet subsequently sold the majority, if not all, of these debt securities to QIBs.

(q) Defendant NatCity Investments, Inc. (“NatCity”) was an underwriter of HealthSouth’s September 2001 Integrated Public Offerings and its May 2002 Integrated Public Offering. In the September 2001 Integrated Public Offerings, NatCity purchased a total of \$6,250,000 of HealthSouth’s September 2001 Unregistered Notes; in the May 2002 Integrated Public Offering, NatCity purchased \$13,623,587 of HealthSouth’s May 2002 Unregistered Notes. NatCity subsequently sold the majority, if not all, of these debt securities to QIBs.

(r) Defendant Banc of America Securities, LLC (“BOA Securities”), a subsidiary of Bank of America Corp., was an underwriter of HealthSouth’s May 2002 Integrated Public Offering, in which BOA Securities purchased \$159,010,238 of HealthSouth’s May 2002

Unregistered Notes. BOA Securities subsequently sold the majority, if not all, of these debt securities to QIBs.

(s) Defendant NationsBanc Montgomery Securities, LLC (“NationsBanc”), now d/b/a Banc of America Securities, LLC, a subsidiary of Bank of America Corp., was an underwriter of HealthSouth’s March 1998 Integrated Public Offering, and of its June 1998 Integrated Public Offerings. In the March 1998 Integrated Public Offering, NationsBanc purchased \$5,750,000 of HealthSouth’s March 1998 Unregistered Notes; in the June 1998 Integrated Public Offering, NationsBanc purchased a total of \$47,500,000 of HealthSouth’s June 1998 Unregistered Notes. NationsBanc subsequently sold the majority, if not all, of these debt securities to QIBs. (Together, defendants BOA Securities and NationsBanc shall be referred to as the “Bank of America Corp. Underwriters.”)

#### **Individual Underwriter Defendants**

130. Benjamin D. Lorello and William C. McGahan.

(a) Defendants Lorello and McGahan were HealthSouth’s top investment bankers from at least the time of the Company’s initial public offering in September 1986 through early 2003. Lorello and McGahan provided these services first while they were at Smith Barney and Salomon Brothers as part of the healthcare group (Smith Barney and Salomon Brothers collectively during the time Lorello and McGahan worked there, are referred to herein as “Citi/Salomon”).

(b) When Lorello and McGahan left Citi/Salomon in March 1999 to join UBS as part of its Global HealthCare Finance Group, they continued their substantial relationship with the Company. Defendant Lorello first served as the head of Citi/Salomon’s healthcare group and then, in 1999, as the head of UBS’s Global HealthCare Finance Group. Defendant McGahan served as the coverage officer for HealthSouth, initially at Citi/Salomon with Lorello, and then, starting in 1999, at UBS. Given their close and longstanding lucrative relationship with Scrushy, Lorello and McGahan

– upon moving to UBS in March 1999, Lorello’s group, which included McGahan, received a three-year pay package of \$70 million. These fantastic pay packages were based on Lorello’s and McGahan’s book of investment banking business of healthcare companies, of which HealthSouth was a “crown jewel.”

(c) Lorello and McGahan’s longstanding and substantial relationship, with HealthSouth and many of the Individual Defendants, in particular Scrushy, spanned more than 16 years. Lorello and McGahan regularly made presentations to HealthSouth’s Board of Directors in connection with a variety of equity and debt financings, several short- and long-term bank credit facilities, and numerous business combinations. See Appendix 5, showing that Lorello and McGahan attended at least nine of HealthSouth’s Board meetings between 1997 and 2002. These transactions required Lorello, McGahan, Citi/Salomon and UBS to obtain substantial knowledge about HealthSouth during the course of their due diligence. Lorello and McGahan worked very closely together. Though Lorello was senior to McGahan, who had greater responsibility for the day-to-day relationship with the Company, McGahan kept Lorello informed of all significant HealthSouth matters. In sworn testimony provided to the E&C Committee at the November 5, 2003 hearing conducted in connection with the investigation into HealthSouth’s massive and longstanding accounting fraud, McGahan explained that he regularly reported to Lorello in order to keep Lorello informed of any issues concerning HealthSouth:

Rep Walden:	Mr. McGahan, how often did you report to Mr. Lorello on HealthSouth issues?
Mr. McGahan:	Periodically, when I would see him and in the office and when there was something to talk about.
Rep Walden:	When there was something to talk about? Does that mean every time there was something to talk about, you fed back to Mr. Lorello?
Mr. McGahan:	Mr. Lorello would keep track of the pipeline of transactions and I’d keep them updated on things that were being contemplated or other transactions that were coming down the pipe. If there was also any significant items that would come up, I would keep him informed that it was periodically -- I covered about 100 healthcare

companies, and so I would keep him informed on those as things were going on.

(d) In particular, Lorello and McGahan, helped HealthSouth raise more than \$3.8 billion in public debt financing in 11 transactions over 13 years. In fact, it was Lorello and McGahan, then at Citi/Salomon, who presented for the Board's consideration a proposal for HealthSouth to obtain debt financing through a Rule 144A exchange Integrated Public Offering.

(e) Under the leadership of Lorello and McGahan, Citi/Salomon and then UBS assisted HealthSouth in more than sixty transactions. Pursuant to Lorello's and McGahan's advice, and under their guidance, HealthSouth raised more than \$3.3 billion in public debt through six separate Integrated Public Offerings of eight debt securities using the Rule 144A exchange structure. Lorello, along with McGahan, served as the lead investment bankers for each one of those Integrated Public Offerings. Lorello and McGahan also advised HealthSouth on a variety of business combinations that UBS valued at more than \$7.7 billion.

(f) As the HealthSouth scandal unfolded, McGahan suddenly resigned in April 2003 claiming he wanted to spend more time with his family. Lorello, while he remains with UBS, has been exposed to be one of Wall Street's master manipulators. Lorello's history as a Wall Street financier presents a very checkered past. Lorello and/or McGahan were the chief investment bankers and garnered huge fees in connection with deals relating to several publicly-traded healthcare companies in which investors lost huge sums of money. One example is Integrated Health Services, where Lorello and McGahan (then with Citi/Salomon) took the company public in 1991, did \$4.8 billion worth of deals for the company and saw its stock peak at \$37 before the company collapsed into bankruptcy in early 2000. Ribapharm and Five Star Quality Care are two other examples of Lorello and McGahan sponsored public healthcare companies that have cost

investors millions of dollars. As one Wall Street banker commented, “Ben does deals no one else will touch.” And, according to an April 28, 2003 Fortune Magazine article:

***Behind every great corporate empire they say, lies a filthy-rich investment banker. For HealthSouth, that banker is Ben Lorello, a brash Wall Street kingpin.*** Though HealthSouth is most closely associated with its recently deposed CEO and founder, Richard Scrushy, Wall Street insiders say the long arm of Lorello held considerable sway over the company.

***Lorello heads UBS Warburg’s health-care investment banking group. Wall Streeters say he and his partner William McGahan, who resigned suddenly on April 10, are the kinds of bankers who give bankers a bad name (that’s saying something). In other words, they’re fee-hungry, not particularly concerned about investors, and often ill-tempered.*** McGahan is known for his short fuse, Lorello for his insults (the latter was once overheard saying, in his gravelly monotone, “If you were a stock, I’d short you”).

\* \* \*

Lorello ... came to UBS in 1999 for a reported three-year pay package worth \$70 million. He and McGahan, who handled the day-to-day relationship with HealthSouth, helped it raise billions of capital, ***netting UBS millions*** in fees. Prior to that Lorello and McGahan worked to build HealthSouth deal by deal beginning in the mid-’80s, first at Smith Barney, then at Salomon Smith Barney.

HealthSouth wasn’t the only Lorello client to run into trouble.... ***“A company would tell me they were doing a deal,” says a health-care analyst at a major New York hedge fund, “and I would say to management, ‘Please tell me you aren’t doing it with Ben Lorello.’ Everything he touched blew up.”***

131. Defendant Capek was the Managing Director of UBS’s Equity Research and HealthCare Group from May 1999 and throughout the Class Period. Capek was the UBS analyst responsible for covering HealthSouth. In fact, as described in more detail below, at Lorello’s and McGahan’s invitation, Scrushy handpicked Capek to become UBS’s analyst for HealthSouth in May 1999. At UBS, Capek immediately issued a “Strong Buy” recommendation for HealthSouth. Capek maintained that recommendation until August 27, 2002, when the SEC’s investigation into Scrushy’s insider stock sales became public, even though, as described below, he knew that the Company was falsifying its financial statements and did not believe the Company actually deserved the rating. Even after the investigation into Scrushy’s insider sales became public, Capek maintained a “Buy”

rating for HealthSouth, and was the last analyst to drop a “Buy” rating on the Company. Capek was fired after his damning e-mails calling HealthSouth a “mess” and a “pig” were obtained by a Congressional committee through a subpoena.

### Summary of Claims Against the Defendants

DEFENDANTS	§10(b)	§20(a)	§20(A)	§11	§12(a)(2)	§14(a)	§15
Scrushy	x	x		x		x	x
Owens	x	x		x		x	x
Smith	x	x		x			x
Martin	x	x		x			x
Thomson	x	x					
House	x	x	x	x		x	x
Carman	x	x	x				
Bennett	x	x		x		x	x
D. Brown	x	x		x		x	x
Harris	x	x					
McVay	x	x					
Hale	x	x					
Taylor	x	x					
Tanner	x	x		x		x	x
Foster	x	x					
Beam	x	x		x			x
Celeste	x	x		x			x
Watkins	x	x		x		x	x
Ayers	x	x					
Livesay	x	x					
Edwards	x	x					
Morgan	x	x					
Valentine	x	x					
Givens	x	x		x		x	x
Strong	x	x		x		x	x
Newhall	x	x		x		x	x
Horton	x	x					
Striplin	x	x		x			x
Botts	x	x					
Hicks	x	x					
J. Brown	x	x					
Fowler	x	x					
J. Jones		x		x			x
S. Jones	x	x					
Gordon		x		x		x	x
Chamberlain		x		x		x	x
Crawford		x		x		x	x
HealthSouth	x	x		x	x		x

DEFENDANTS	§10(b)	§20(a)	§20(A)	§11	§12(a)(2)	§14(a)	§15
E&Y	x			x			
UBS (and related entities)	x	x		x	x		x
Citi/Salomon (and related entities)	x	x		x	x		
J.P. Morgan Securities	x			x	x		
Bear Stearns	x			x	x		
Cowen	x			x	x		
Chase	x			x	x		
CSFB	x			x	x		
Morgan Stanley	x			x	x		
Goldman	x			x	x		
Merrill Lynch	x			x	x		
Deutsche Bank	x			x	x		
Deutsche Bank Alex. Brown	x			x	x		
First Union	x			x	x		
Scotia Capital	x			x	x		
Jefferies	x			x	x		
Lehman Brothers	x			x	x		
BNY	x			x	x		
Fleet	x			x	x		
NatCity	x			x	x		
BOA Securities	x			x	x		
Nations Banc	x			x	x		
Lorello	x	x		x			
McGahan	x	x		x			
Capek	x	x					

**Senior Officer Defendants’, Employee Defendants’  
and Director Defendants’ Involvement in Scheme**

132. The Senior Officer Defendants were the Company’s principal officers and controlled HealthSouth and its public disclosures. Each of them made false and misleading statements and/or failed to disclose material adverse information concerning the Company’s business and operations during the Class Period, as detailed herein. Because of their senior executive positions with the Company, and their participation as “family members” at “family meetings,” the Senior Officer

Defendants were integrally involved in the scheme led by Scrushy to inflate HealthSouth's financial results and the market price of its stock.

133. Moreover, Scrushy and/or Owens would preside at weekly "Monday Morning Meetings" at which approximately 65 to 100 of HealthSouth's managers make presentations to Scrushy. The Monday Morning Meetings, which lasted approximately one and one half hours, were intended to generally inform Scrushy of any developments and activities for each executive and manager's region, division, or group from the period since the previous Monday Morning Meeting, and of their planned activities for the next several weeks. In advance of the meetings, the managers would prepare an "Activity Report," outlining such developments and activities. The Activity Reports could be viewed by Scrushy during Monday Morning Meetings using a laptop computer as the presentations were made. Smith and Martin regularly attended on behalf of the Finance Department during their respective tenures as Chief Financial Officer. At the Monday Morning Meetings, the Senior Officer and Employee Defendants received reports from the heads of HealthSouth's financial, regulatory and operational departments on developments within their departments and matters of a material nature that had arisen. As a result of these weekly meetings and the numerous other communications to which the Senior Officer and Employee Defendants were privy, each of them was fully familiar with the status of HealthSouth's regulatory, financial and business affairs.

134. It is appropriate to treat the Senior Officer, Employee and Director Defendants as a group for pleading purposes and to presume that the false, misleading, and incomplete information conveyed in the Company's public filings, press releases, interviews, and other statements, as alleged herein, were the collective actions of these defendants. Each of those officers and/or directors of HealthSouth, by virtue of his or her high-level position with the Company, directly participated in the management of the Company, was directly involved in the day-to-day operations



of the Company at the highest levels, and was privy to confidential proprietary information concerning the Company and its business, operations, growth, financial statements, and financial condition, as alleged herein. Moreover, by virtue of their participation in “family meetings,” Scrushy, Owens, Smith, Martin, Beam, McVay, Bennett, Tanner, Harris, Livesay, Ayers, Edwards, Morgan, Valentine, Botts, Hicks, S. Jones and D. Brown knowingly or recklessly made the materially false and misleading statements alleged herein; were involved in drafting, producing, reviewing and/or disseminating the statements; or approved or ratified the statements, in violation of the federal securities laws.

135. As officers and/or directors and controlling persons of a publicly held corporation whose common stock was, and is, registered with the SEC pursuant to the Exchange Act, traded on the NYSE, and governed by the provisions of the federal securities laws, each of the Senior Officer and Director Defendants had a duty to disseminate promptly accurate information with respect to the Company’s financial condition and performance, growth, operations, financial statements, revenues, earnings, and present and future business prospects, and to correct any previously issued statements that were materially misleading or untrue, so that the market price of HealthSouth common stock would be based upon truthful and accurate information. The Senior Officer and Director Defendants’ misrepresentations and materially incomplete statements during the Class Period violated these specific requirements and obligations.

136. Because of their positions of control and authority as officers and/or directors of the Company, each of the Senior Officer and Director Defendants was able to and did control the content of the various SEC filings, press releases and other public statements issued by or on behalf of the Company during the Class Period. Each Senior Officer and Director Defendant was provided with copies of the documents alleged herein to be misleading prior to or shortly after their issuance and/or had the ability and/or opportunity to prevent their issuance or cause them to be corrected.

Accordingly, each of the Senior Officer and Director Defendants is responsible for the accuracy of the public reports and releases detailed herein and is therefore primarily liable for the misrepresentations and materially incomplete statements contained therein.

137. Each of the defendants above is liable as a participant in a wrongful scheme and course of business that operated as a fraud or deceit on those who purchased or otherwise acquired HealthSouth securities during the Class Period by disseminating materially false and misleading statements and/or concealing material adverse facts. The scheme deceived the investing public regarding HealthSouth's current and past business, operations, and the intrinsic value of the Company's securities; caused plaintiffs and other members of the Stockholder and Bond Classes to purchase HealthSouth securities at artificially inflated prices; and allowed Scrushy and other corporate insiders to profit personally from unlawful insider trading.

### **Insider Selling**

138. While HealthSouth's top insiders were issuing favorable statements about HealthSouth, a number of HealthSouth's insiders sold over 17.1 million shares of HealthSouth stock, for more than \$305 million in illegal insider trading proceeds – over 69.2% of their collective holdings of HealthSouth stock – to personally profit from the artificial inflation in HealthSouth's stock price. Notwithstanding their access to material non-public information and their duty to disclose all material facts before trading in HealthSouth, they sold significant amounts of their HealthSouth stock at artificially inflated prices. Defendants' insider selling during the Class Period is summarized below:

<b>Defendants</b>	<b>Position</b>	<b>Available Holdings **</b>	<b>Class Period Sales</b>	<b>Proceeds From Sales</b>	<b>% of Holdings Sold (Common Stk/ and options exercised)</b>
R. Scrushy	Chairman/CEO/Dir (1996 - 2002)	15,341,791	11,782,130	\$207,336,914	76.80%
L. House	Director (1996 - 1997)	484,600	482,996	\$13,082,880	99.67%
J. Bennett	Pres/COO/Dir	1,252,959	199,900	\$5,287,199	15.95%

M. Martin	(1996 - 2000) SVP/Treas (1996); EVP/CFO/Treas/Dir (1998 - 1999)	563,746	125,000	\$3,375,000	22.17%
A. Tanner	Secretary/EVP/Dir (1996 - 1999)	501,358	278,350	\$7,335,881	55.52%
W. Owens	EVP/CFO/Dir (2001); Pres/COO/Dir (2002)	301,000	226,000	\$5,957,420	75.08%
R. Thomson	Pres. Inpatient Operations	523,637	263,500	\$5,849,458	50.32%
T. Carman	EVP -- Corp. Development	795,000	485,000	\$10,101,045	61.01%
P. Daryl Brown	Pres. Healthsouth Outpatient Centers (1996 - 1999)	819,783	179,810	\$4,813,689	21.93%
P. Foster	Pres. Ambulatory Services – West	456,949	381,337	\$6,615,835	83.45%
P. Watkins	Director (1996 - 2002)	294,254	210,000	\$4,998,800	71.37%
R. Celeste	Director (1996)	60,000	60,000	\$1,625,100	100.00%
A. Beam Jr.	EVP/CFO/Dir (1996 - 1997)	203,620	100,000	\$2,759,000	49.11%
W. Smith	SVP Finance, Controller (2000); EVP/CFO (2001); EVP Inpatient Operations (2002)	92,650	92,650	\$1,608,136	100.00%
B. Hale	EVP and Secretary	112,500	42,200	\$650,972	37.51%
G. Strong	Director	448,350	115,866	\$1,532,431	25.84%
C. Newhall	Director	1,914,627	1,673,781	\$14,406,547	87.42%
C. Sage Givens	Director	273,000	240,000	\$4,290,733	87.91%
M. McVay	Executive V.P. and Treasurer	69,514	50,000	\$865,910	71.93%
W. Horton	Executive V.P.	235,000	125,000	\$2,217,150	53.19%
S. Jones	SVP Finance – Reimbursement	28,750	28,750	\$498,114	100.00%
Totals:		24,773,088	17,142,270	\$305,208,213	69.20%
Avg. sales price:		\$17.804			

\*\* Includes common stock and options exercised.

139. Defendants' insider trading is described in detail in Appendix 3.

### **Healthsouth's Board of Directors Recklessly Allows the Misconduct to Occur and Continue Unabated**

140. Five of the outside Directors (Givens, Watkins, Strong, Celeste, and Newhall) engaged in insider sales and five outside Directors (Givens, Watkins, Strong, Newhall and Gordon) signed false Registration Statements. See App. 3. HealthSouth's Board of Directors and its

committees had the ability, but failed, to control the conduct that ultimately led to HealthSouth's financial fraud. The directors turned a blind eye to Scrushy's shenanigans, ignored red flags, failed to conduct inquiries and failed to ensure that adequate compliance procedures were established. HealthSouth's Board took no action to prevent Scrushy and the other Individual Defendants from engaging in fraudulent misconduct.

141. Internal auditor Greg Smith testified before Congress that the Internal Audit Department had no meetings with the Board's Audit Committee separate from the full Board or E&Y. Moreover, in the year 2001, the Company possesses minutes from just a single audit committee meeting.

142. As indicated on Appendix 5, the HealthSouth directors and other individual defendants attended the Board meetings when E&Y made presentations on HealthSouth's financial statements, representatives of UBS and Citi/Salomon, including defendants Lorello and McGahan, gave presentations on HealthSouth's issuance of debt and equity, and a representative of U.S. Strategies, a Washington-based lobbyist, gave presentations on the status of the BBA and PPS.<sup>7</sup>

143. The HealthSouth directors described in Appendix 1 served on the HealthSouth Board of Directors and the indicated Board Committees for the period indicated.

### **OVERVIEW OF THE SCHEME**

144. HealthSouth was formed in 1984, and due to an aggressive acquisition spree directed by Scrushy, by 2002 it had become the nation's largest provider of outpatient surgery and rehabilitative healthcare services, with more than 1,800 patient care locations in each of the 50 states and foreign countries as well. *See* App. 8 (listing HealthSouth's acquisitions from 1986 to 1999).

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<sup>7</sup> PPS refers to the prospective payment system. Certain of HealthSouth's services were exempt from this system. Under the BBA, many PPS exempt services would be subject to reduced reimbursement.

HealthSouth has two primary business segments, inpatient services and outpatient services. The inpatient services segment includes the PPS hospitals, the PPS-exempt hospitals and the home health operations. According to the Company, it derives over 60% of its revenue from Medicare. The outpatient segment includes outpatient rehabilitation, imaging and ambulatory surgery centers and it receives less than 35% of its revenue from Medicare.

145. Prior to and during the Class Period, defendants falsified HealthSouth's financial statements, intentionally understated the adverse impact of the BBA upon HealthSouth's operations, and concealed its fraudulent overbilling of Medicare. As it became evident that HealthSouth's manipulations would be exposed, Scrushy unloaded some \$74 million worth of his HealthSouth stock in May 2002. In 2002, defendants used the issuance of CMS Transmittal 1753 as a pretext for concealing the Overbilling Fraud.

#### **HealthSouth's False Financial Statements**

146. The financial fraud at HealthSouth is in the same league as Enron and WorldCom in terms of the magnitude of the fraud. The Company's financial results were misstated over several years by more than \$2.7 billion. Absent the defendants' manipulations, HealthSouth's results would have been materially worse than the amounts reported by the Company during the Class Period.

147. HealthSouth's operations are subject to extensive regulation. Substantially all of the Company's revenues are derived from private and governmental third-party payors through a billing reimbursement process that is subject to stringent cost controls. Nonetheless, under the leadership of defendant Scrushy, the Company consistently reported and represented that it had achieved revenues and earnings growth both internally and through acquisitions, which accelerated the Company's rate of growth. This reported growth and the representations relating thereto were materially false and were based on the financial fraud and Overbilling Fraud alleged herein. These financial statements were presented in violation of GAAP and SEC rules. As U.S. Attorney Alice Martin noted, "[t]his is

not a mere ‘accounting fraud,’ but rather a business scheme to fraudulently boost HealthSouth’s reported earnings.” *Two HealthSouth Execs Reach Plea Agreement*, CBS Marketwatch, July 31, 2003.

148. During the Class Period, HealthSouth reported favorable but false financial results. Scrushy knew what it took to remain a Wall Street favorite. As reported in the June 21, 1999 issue of *Fortune*: “Most important, Scrushy always made it a point to meet or beat Wall Street’s earnings expectations.” Unfortunately for investors, Scrushy and his cohorts met those expectations by deliberately falsifying the Company’s financial statements.

149. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. Regulation S-X (17 C.F.R. §210.4-01(a)(1)) states that financial statements filed with the SEC that are not prepared in compliance with GAAP are presumed to be misleading and inaccurate. Reg S-X requires that interim financial statements also must comply with GAAP, with the exception that they need not include disclosure that would be duplicative of disclosures accompanying annual financial statements. (17 C.F.R. §210.10-01(a).)

150. Moreover, pursuant to §13(b)(2) of the Exchange Act, HealthSouth was required to “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer and devise and maintain a system of internal accounting control sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management’s general or specific authorization; transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles....”

151. GAAP, as described by FASB Statement of Concepts No. 5, requires that revenue not be recognized unless it is earned and is realizable. *See also* SEC Staff Accounting Bulletin No. 101.

152. During the Class Period, HealthSouth reported as revenue illegal billings to Medicare and third-party payors to which HealthSouth was not entitled.

153. Expenses are to be recorded in the period they are incurred. *See* FASB Statement of Concepts No. 5, at 85-87. GAAP, as described by FASB Statement of Concepts No. 2, requires that financial reporting should represent what it purports to represent.

154. In violation of GAAP, HealthSouth reported as assets items that were actually expenses. This was accomplished by means of unsupported journal entries to reduce expenses and increase assets. These entries had no justification but were made so that HealthSouth could report false and misleading financial results to the investing public.

155. Public companies, such as HealthSouth, typically report the financial results of their operations in financial statements that include both an Income Statement and a Balance Sheet. A company's Income Statement reports, among other things, revenue recognized, expenses incurred, and income earned during a stated period of time – usually for a fiscal quarter or fiscal year. Within an Income Statement, expenses are generally subtracted from revenues to calculate net income. A company's Balance Sheet reports, among other things, the assets and liabilities of the company at a given point in time, usually at the end of a fiscal quarter or the end of a fiscal year.

156. In preparing and maintaining HealthSouth's books and records, HealthSouth's accounting staff employed certain accounting principles and financial statement line items specific to healthcare service providers. One such Income Statement line item was "contractual adjustments." Contractual adjustments are designed to serve as a "valuation" account, operated to deduct from revenue the estimated difference between the gross amount charged to a patient and the amount that is ultimately paid by the patient's healthcare insurer to the healthcare provider. HealthSouth used contractual adjustments in preparing its periodic reports filed with the SEC.

157. Because GAAP requires that any increase in revenue or decrease in expenses be matched with either an increase in assets or decrease in liabilities on the Balance Sheet, any decrease of the contractual adjustment account (resulting in an increase in revenues) would require a corresponding entry on the Balance Sheet.

158. The falsifications involved making thousands of phony entries to various HealthSouth accounts, including at more than 1,000 of HealthSouth's facilities; when some of these facilities were sold, HealthSouth would move hundreds of millions of dollars of fraudulently created assets to other accounts in HealthSouth's books and records, frequently to the cash account.

159. Between 1996 and the second quarter of 2002, HealthSouth's earnings, identified as "Income Before Income Taxes And Minority Interests," were inflated by at least \$2.74 billion, or 2,100% of reported net income for this period, as follows:

Income (Loss) Before Income Taxes and Minority Interests (\$MM)	1996 Form 10-K	1997 Form 10-K	1998 Form 10-K	1999 Form 10-K	2000 Form 10-K	2001 Form 10-K	6 mos. ended 6/30/02	Total
As reported	\$440	\$601	\$267	\$230	\$559	\$434	\$337	\$2,869
Actual amounts	\$370	(\$99)	(\$283)	(\$160)	\$209	(\$16)	\$107	\$129
Difference	\$70	\$700	\$550	\$390	\$350	\$450	\$230	\$2,740

### **The SARC Report Provides Further Details of the Accounting Misstatements**

160. The SARC Report describes the details of defendants' longstanding intentional financial manipulations as a result of outright fraud and aggressive and questionable accounting practices. In the report, the SARC summarized the components of defendants' accounting fraud as follows:

Stated most simply, the fraud was accomplished by making over \$2.7 billion in false or unsupported entries in the Company's accounting systems. These improper accounting entries, made for the purpose of inflating HealthSouth's earnings, took two principal forms: (1) exaggeration of reported revenue, primarily thorough reductions to contractual adjustment accounts, and (2) failure to properly characterize and record operating expenses. The chart below illustrates the



categories in which fraudulent entries were identified by the Committee and the impact of those entries on the Company's reported earnings:

Impact To Income Before Minority Interest And Taxes (millions of dollars)

Reduction of Contractual Allowances or Operating Expenses	2,203
Acquisition Accounting	421
Bonus Accounting	52
Investment Accounting	17
Facility Contractual Accounting	19
Third-Party Transaction Accounting	29
	<hr/> 2,741

As illustrated below, the fraud consistently and significantly affected the Company's reported income:

Improper Adjustments To Income Before Taxes And Minority Interests

	1996	1997	1998	1999	2000	2001	2002
Reported	991,480,807	1,485,757,791	2,067,102,113	1,295,544,178	1,370,911,721	1,493,174,801	1,547,458,781
Adjusted	891,838,188	1,086,463,765	1,477,895,196	892,058,387	1,021,960,053	917,140,318	1,322,027,649

161. The SARC also identified \$632 million in other accounting issues and transactions, which "were sufficiently aggressive or questionable to warrant discussion." To the extent the SARC quantified them, it summarized those items as follows:

Capitalization:

Operating Expenses and Start Up Costs	156
Inventory/Supplies	49
"Borrowed" Depreciation	8
Assets at Closed Facilities	62
Leased Assets	82
Audit Adjustments	53
Facility Contractual Accounting:	
Reported Under Reserve	49
Recalculated Reserve	155
Employee and Other Loans	18
	<hr/> 632

162. The SARC cautioned that "[t]he Committee's work does not represent an audit of HealthSouth's financial statements in accordance with Generally Accepted Auditing Standards ("GAAS"). The Committee therefore expresses no opinion as to whether transactions or accounting

entries other than those identified as fraudulent were appropriately recorded in the Company's records or properly reflected in its financial statements." The SARC further warned:

There are additional accounting issues involving substantial dollar amounts that the Company currently is evaluating, but that also were not within the scope of the committee's inquiry. These include, but are not limited to, recognition of impairment of property, plant and equipment, goodwill, and other long-lived assets; the collectibility of, and the determination of appropriate reserves for, accounts receivable; the effect, if any, of restatements on minority interest and incentive compensation calculations; the propriety of consolidation of affiliated entities; tax reporting and accounting for appropriate tax provisions after restatements; and Medicare cost reporting and accounting for settlements and/or retroactive adjustments. The Company is in the process of evaluating these and other matters.

### **Contractual Adjustments/Improper Classification of Expenses**

163. The largest portion of accounting misstatements were in the form of improper reduction of the contractual adjustment account and the improper classification of expenses. The SARC described HealthSouth's methodology for recording revenue and contractual adjustments as follows:

HealthSouth sets "standard" charges for each patient service it provides. The Company's revenue, however, is determined by the amount it actually receives for those services and, like virtually all health care providers, HealthSouth rarely collects its standard charge for any particular service. Instead, both its contractual arrangements with private payors and the reimbursement rates established by government programs such as Medicare typically provide for payment at less than standard rates.

The Company historically has accounted for the provision of health care services by recording both its standard charge for the service and a contractual adjustment. The first entry essentially is a constant, unaffected by the amount actually to be paid by or on behalf of a patient. The second is a variable, representing the Company's estimate of a discount from the standard charge which it does not expect to collect. The amount of the variable - the contractual adjustment - is based on the source of payment, since different payors may reimburse different amounts for the same service. The difference between the standard charge and the contractual adjustment, frequently a significant amount, represents the Company's net operating revenue.

164. The SARC went on to describe how defendants fraudulently reduced contractual adjustments to increase revenue by more than \$2.2 billion:

During the second quarter of 1996, HealthSouth began what was to become a systematic practice of reducing contractual adjustments – i.e., narrowing the gap between standard charges and anticipated reimbursements – even though the applicable contractual adjustments had not actually changed and there was otherwise no support for the reductions. This practice continued without interruption in every reporting period through mid-2002. At the same time, the Company improperly reclassified a number of operating expenses to make it appear as if the expenses were never incurred. HealthSouth fabricated hundreds of millions of dollars in pre-tax earnings during the period these manipulations occurred. The following chart presents the income statement impact of the improper adjustments on a quarterly, annual, and cumulative basis:

Improper Adjustments To Income Before Taxes And Minority Interests  
(millions of dollars)

	1Q	2Q	3Q	4Q	Total
1996		7.37	10.79	70.20	88.36
1997	46.76	75.73	104.95	168.60	396.04
1998	100.23	127.17	167.17	208.47	603.04
1999	85.43	129.79	63.80	123.94	402.96
2000	25.40	51.27	113.84	158.44	348.95
2001	60.53	228.00	120.04	167.46	576.03
2002	76.33	109.59	49.31	(9.80)	225.43
					2,641

165. The SARC also found that HealthSouth’s operational divisions employed no consistent methodology to estimate or establish contractual adjustments and allowances in the first place. During the period between 1999 and 2002, the Company’s Outpatient and Surgery Divisions estimated current contractual adjustments by reference to their prior revenue collection experience, as reflected in so called “zero balance reports.” These reports summarized, for an established historical period, the settlement of patient accounts receivables by cash collections, contractual adjustments, and bad debt write-offs. The SARC found little uniformity in the use of zero balance reports, however, and consequently identified numerous inconsistencies in the manner by which individual facilities used information contained in the reports to estimate contractual adjustment allowances. The SARC recalculated the contractual allowances for the Outpatient and Surgery Divisions using a consistent three-month zero balance report, rather than the previously recorded contractual allowance, and quantified a difference of \$155 million, reflected as follows:

Under/(Over) Contractual Adjustments  
As Computed In The Recalculated Zero Balance Report (millions of dollars)

	Outpatient Division			
	1Q	2Q	3Q	4Q
1999	26.93	63.90	116.00	131.67
2000	37.60	83.24	123.97	150.57
2001	31.72	63.09	85.41	102.79
2002	23.34	53.09	85.08	119.82

166. The fabrication of HealthSouth's income between 1996 and 2002 resulted in corresponding balance sheet manipulations. According to the SARC, "[t]hose manipulations resulted in unsupported entries that affected virtually all of the Company's balance sheet asset accounts."

#### **Improper Entries on Facilities' Results**

167. In the days following the close of each quarter, HealthSouth's operating facilities submitted financial reporting information to the corporate accounting department, which was responsible for preparing HealthSouth's consolidated financial statements. In addition to finalizing facility reporting information, corporate accounting also recorded a variety of other entries, including tax estimates and "minority interests" to produce "first run" consolidated financial statements. For the most part, improper accounting entries were made after "first run" consolidation, rather than in conjunction with proper entries made in the ordinary course of the Company's daily operations.

168. Unexpected or unexplained revenue increases and expense reductions, which improved the earnings of individual facilities, became so institutionalized at HealthSouth that, according to the SARC, they were referred to by corporate accountants as "management entries" and by operations personnel as "gifts," "pixie dust," "fairy dust," or "candy." Indeed, annual budget planning discussions among some operations personnel reportedly included the subject of whether corporate "gifts" would be available to help meet revenue and earnings projections.

169. Moreover, HealthSouth's assets as of June 30, 2002 were overstated by \$2.7 billion, including \$370 million in cash and more than \$1.0 billion in fictitious assets classified as AP Summary and included in property plant and equipment, representing one-third of the total PPE reported. The fictitious cash amount represented more than half of HealthSouth's reported cash balance in 2002. The fictitious PPE assets were allocated among the Company's health care facilities. HealthSouth's investment in the stock of another company and its investment in an assisted living center were also overstated by \$27 million and \$13 million, respectively. Defendants then compounded the fraud by seeking reimbursement from Medicare for that portion of the inflated PPE assets that were purportedly used by HealthSouth's health care facilities to treat Medicare patients.

170. The SARC found that the overstatement of assets increased steadily during the relevant time period due to improper adjustments to the fixed asset system. The overstatement (in millions of dollars) was as follows:

	1Q	2Q	3Q	4Q
1998	64.34	123.52	202.16	305.09
1999	302.77	307.07	302.05	448.87
2000	488.56	572.89	573.19	697.19
2001	754.64	716.02	796.46	854.20
2002	984.13	1035.07	1034.74	1032.95

171. The SARC explained that the Company's methods for recording phony balance sheet entries were unusual:

HealthSouth's accounting for fraudulent balance sheet entries also departed from customary bookkeeping conventions. Under ordinary circumstances, accounting entries that affect income statement accounts should result in corresponding entries to balance sheet accounts (e.g., contractual adjustment to contractual allowance, operating expense to accounts payable). The Committee found that such corresponding entries largely were absent from the accounting for fraudulent adjustments. Instead, improper income statement entries generally resulted in an increase to a corporate suspense account, which then was reduced by a series of inter-company transfers that increased the assets on various facilities' balance sheets. The allocation of false entries to balance sheet accounts was determined principally by considering the facilities and accounts to which additions

would be least likely to attract attention. Consequently, changes on the income statement of a particular facility did not necessarily (or even usually) equate to changes on the same facility's balance sheet.

Moreover, many of the improper adjustments to facility balance sheets changed from quarter to quarter. A number of the suspense-to-other balance sheet account transfers were self-reversing, and thus were returned automatically to a suspense account in the succeeding quarter. When that quarter ended, the suspense account balance once again was allocated among facility balance sheet accounts, but neither the accounts selected in the reallocation nor the amounts earmarked for those accounts matched the allocations from previous quarters.

172. As the SARC revealed, defendants, among other things, created \$1.033 million of fictitious fixed assets. These phony "assets" were not recorded through HealthSouth's normal procedure for recording legitimate fixed assets, but were created out of thin air without the customary journal entries and required supporting documentation. The SARC report described the process as follows:

In the normal course of HealthSouth's business, each addition to plant, property and equipment – everything from real estate to medical equipment – should have been reflected by a general ledger entry and supported by appropriate documentation. The Company's physical assets were monitored by its fixed asset department, which generated a detailed asset list and manually reconciled the list to the general ledger each month. To account for assets that did not exist, and thus would not have been recorded in HealthSouth's accounts payable system or processed in its general ledger system in the normal fashion, fictitious assets were added to the fixed asset list during monthly reconciliations.

173. The SARC went on to explain that the assets "were processed to the general ledger by external upload," which is not the customary method, that most of them were identified "only as 'AP SUMMARY,'" which differed from the normal classification, and that "[g]iven the method by which non-existent fixed assets were allocated to a particular facility's books, some AP SUMMARY entries had dollar values exceeding the cost of any asset the facility would have been likely to acquire." In or around January 1999, HealthSouth added to its general ledger additional fixed asset accounts, denominated "New Cap" accounts; these accounts, for the most part, contained only entries for phony fixed assets that bore the "AP SUMMARY" designation.

174. The SARC also described the basic accounting ledgerdomain defendants used to overstate HealthSouth’s reported cash balances by approximately \$373 million:

Between 1999 and 2002, a former employee responsible for preparing these reconciliations regularly misstated either the 1015 Account general ledger balance or transactional activity in the 1015 Account. For example, if an improper entry of \$20 million were recorded, the bank reconciliation would misstate the general ledger account balance, or misstate amounts transferred to or from the 1015 Account, by \$20 million. These misstatements had the net effect of increasing the balance in the 1015 Account.

To misstate transactional activity, “specific items totaling the amount of the misstatement were selected and removed from the transactional activity detail that accompanied the reconciliations.”

The amount by which cash was misstated each quarter of 1999–2002, due to manipulations in the 1015 Account, the corporate consolidation account, are as follows:

Unsupported Entries To 1015 Account (millions of dollars)				
	1Q99	2Q99	3Q99	4Q99
Entry	20.0	20.0		50.7
Reversal		(20.0)	(20.0)	
Net Effect	20.0	20.0	0.0	50.7
	1Q00	2Q00	3Q00	4Q00
Entry	72.4	98.5	137.5	172.0
Reversal	(50.7)	(72.4)	(98.5)	(137.5)
Net Effect	72.4	98.5	137.5	172.0
	1Q01	2Q01	3Q01	4Q01
Entry		305.6	(15.0)	9.4
Reversal	(172.0)		10.8	15.0
Net Effect	0.0	305.6	301.4	325.8
	1Q02	2Q02	3Q02	4Q02
Entry			23.7	23.3
Reversal				
Net Effect	325.8	325.8	349.5	372.8

### Acquisition Accounting

175. HealthSouth concealed the overstatements of income by recording unsupported additions to goodwill by creating excess reserves in connection with acquisitions. The SARC noted that these “cookie jar” or “rainy day” reserves were improperly transferred to suspense accounts (created through HealthSouth’s improper deferral of expenses) or to avoid recognizing expenses.

For example, with respect to the 1997 acquisition of Horizon/CMS and sale (two months later) of the Horizon/CMS nursing homes to Integrated Health Services, Inc. (“IHS”), the SARC reported that defendants again used red flag “suspense accounts” to record journal entries without any support:

When it sold the nursing homes and related assets to IHS, HealthSouth capitalized on an enhanced market demand for long-term care facilities. Rather than properly accounting for the sale to IHS, however, 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. No support for this entry existed. Instead, the \$414 million simply represented a portion of the Company’s overstatement of income in earlier periods.

176. The SARC also found that HealthSouth’s June 1999 acquisition of outpatient rehabilitation centers from the American Rehability Services division of Mariner Post-Acute Network, Inc. (“Rehability”) was used to inflate 2000 income:

The Committee’s accounting advisors obtained account balances, without detail, maintained in Rehability’s accounting system as of June 30, 1999, reconciled these balances to those recorded in the Company’s accounting system as of July 1, 1999, and 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 during 2000 and 2001, thereby improving HealthSouth’s reported operating income.

177. The SARC also states that HealthSouth may 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.

### **Improper Accounting for Bonuses**

178. The SARC report also noted that HealthSouth failed to record \$52 million of employee bonuses it paid “by reclassifying other balance sheet account activity to bonus accruals. A portion of the improper entries recorded incentive payments as bonus accruals, which later were



reduced by increasing other, unrelated balance sheet accounts.” The amount of the understatement was as follows:

	1997	1998	1999	2000	2001	Total
Bonus Payments	32.9	27.8	2.4	4.3	10.9	78.3
Bonus Expense	13.1	6.8	2.3	4.3	0.0	26.5
Recorded Difference	19.8	21.0	0.1	0.0	10.9	51.8

### **Investment Accounting**

179. HealthSouth’s financial statements were also false due to the Company’s improper accounting for investments.

180. **Caremark.** In June 2001, HealthSouth sold its stock in Caremark Rx for a profit of \$19 million. The SARC noted:

Within days of the sale, however, the Company reclassified this income to contractual adjustments, which then were reduced as if the Company had received \$19 million in additional operating revenue. At the same time, the Company altered its investment accounts to reflect that it still held 1.7 million shares of Caremark, even though it no longer owned, and never reacquired, those shares. One year later, the Company again recorded a “sale” of Caremark stock, this time booking income of more than \$17 million attributable to the sale. The two sales of Caremark stock - one real, one illusory - allowed the Company to report improved operating revenue in the second quarter of 2001, to report phantom income in the second quarter of 2002, and to treat an otherwise uncollectible \$7 million receivable as having been paid.

181. **Summerville.** The SARC further concluded that HealthSouth failed to record impairment on Summerville in the value of 5.8 million shares of stock in Summerville HealthCare Group. Pursuant to GAAP, HealthSouth was required to record a loss for other than temporary impairment of this investment.<sup>8</sup> HealthSouth failed to record the impairment despite events that indicated an other-than-temporary impairment:

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<sup>8</sup> See SFAS No. 115, ¶16, which states in part:

If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the

- Subsequent to HealthSouth's investment, HealthSouth declined to invest further when Summerville twice raised additional equity on terms that afforded the new investors a preference over existing shareholders, including HealthSouth.
- Summerville's business, which had been unprofitable, continued to deteriorate and continued to report losses.

182. Ultimately, HealthSouth wrote off its investment in Summerville in July 2002. The SARC believed that the value of HealthSouth's investment was clearly impaired and, therefore, that an impairment adjustment should have been recorded by no later than December 31, 2001.

183. **Source Medical.** Another overstatement described in the SARC Report concerned HealthSouth's transactions with Source Medical Solutions, Inc. HealthSouth inflated its earnings by failing to record a loss it incurred when it sold HCAP, a wireless handheld documentation system by which clinicians could record patient treatment and billing data for immediate electronic processing. In July 2001 the Company sold HCAP to Source Medical in exchange for a \$25 million promissory note. When it sold the HCAP assets, HealthSouth reclassified over \$34 million in costs relating to HCAP development from a capital asset account to an account receivable (and later to a notes receivable) balance due from Source Medical, despite the fact that the true receivable was only \$25 million. By virtue of these entries, HealthSouth avoided recognizing a loss of more than \$9 million on its sale of HCAP assets. By December 31, 2001, the Company's records reflected a total receivable from Source Medical of more than \$81 million. Source Medical's records, however, reflected that it owed the Company \$52 million. By December 31, 2002, the Source Medical receivable balance on HealthSouth's books had grown to more than \$106 million. As of the same date, however, Source Medical's records reflected an indebtedness to HealthSouth of approximately \$73 million, some \$33 million less than HealthSouth claimed was due. In December 2002,

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amount of the write-down shall be included in earnings (that is, accounted for as a realized loss).

according to the SARC, “the Company sought to avoid a write-off of the overstatement by recording an increase of nearly \$29 million in a capital asset account and a corresponding reduction of the Source Medical receivable.”

### **Other Accounting Manipulations.**

184. HealthSouth also engaged in other accounting manipulations that had the effect of overstating its reported assets and earnings. For example, defendants reclassified a variety of current expenses to property, plant and equipment accounts, and then depreciated them over time. As a result, between 1998 and 2002 HealthSouth deferred the recognition of more than \$200 million in expenses.

185. **Start-Up Costs.** The SARC found that following a 1999 agreement with the SEC to discontinue capitalizing start-up costs, the Company continued to do so. The Company posted the costs to the Property, Plant and Equipment account, instead of to Start-Up Costs, and described them incorrectly as “cap salaries,” “legal fees” or “arch fees.” The SARC identified more than \$156 million in such capitalized costs as follows:

Assets Related to Start-Up Costs  
(cumulative, gross depreciation) (in millions of dollars)

	1Q	2Q	3Q	4Q
1998	48.12	55.79	66.86	77.18
1999	81.93	89.13	96.09	103.55
2000	108.76	116.97	130.93	144.05
2001	152.96	151.57	155.44	145.64
2002	146.66	149.35	150.64	156.31

186. **Capitalization of Operating Expenses.** HealthSouth also capitalized certain operating expenses, describing them in the fixed asset system in ways that did not correspond, or in some cases even bear any discernible relationship, to the nature of the costs incurred. The SARC found that promotional and marketing expenses, for example, at times were identified as “cap internet costs.” Some capitalized assets, moreover, were reclassified in book entries after “first-run” consolidation and, like AP SUMMARY assets, may never have existed at all. From 1998 to 2002,

items in this category accounted for approximately \$58.5 million of the \$156 million of capitalized costs identified by the SARC:

Assets Related To Capitalization Of Expenses  
(cumulative, gross of depreciation) (millions of dollars)

	1Q	2Q	3Q	4Q
1998	4.63	5.42	5.64	7.02
1999	7.11	7.19	7.41	31.72
2000	32.29	32.89	37.17	65.84
2001	44.01	42.04	54.23	57.67
2002	56.18	56.07	57.02	58.56

187. **Inventory and Supply Expenses.** HealthSouth’s purchasing policy called for high-level corporate review and approval, by means of a written capital expenditure request, for capital asset purchases of more than \$500. Because many of the purchases were requested by physicians on short notice and used only once, facilities at times ignored the capital request process and simply purchased and expensed these items. Company accountants, aware that facilities made purchases not authorized through a formal expenditure request, periodically reviewed facility inventory and supply accounts and automatically reclassified any purchase exceeding \$500 as a capital asset. The reclassified assets typically were described only generically - as, for example, “surgical instruments” or “medical equipment” – and without regard to whether they remained in use at a facility. These wholesale reclassifications resulted in capital asset treatment for items that did not qualify for such treatment under GAAP. According to the SARC, the Company’s approach provided no means of identifying items that, even if properly classified as capital assets, ultimately were disposed of and thus should not have remained in the Company’s fixed asset listing. The SARC accounting advisors identified nearly \$49 million of reclassified inventory and supply costs between 1999 and 2002:

Assets Related To The Reclassification Of Supply Or Inventory Costs  
(cumulative, gross of depreciation) (millions of dollars)

	1Q	2Q	3Q	4Q
1999	1.58	3.68	6.14	7.94
2000	9.50	11.62	15.47	17.25
2001	18.92	23.29	26.95	39.18
2002	41.48	44.14	48.18	48.64

188. **“Borrowed” Depreciation.** In 1999, as a result of a change in the method the Company used to calculate depreciation, the accumulated depreciation general ledger balances were greater than those reflected in the fixed asset system. As a result, there were instances in which excess accumulated depreciation was transferred, typically from an operating facility to one scheduled for closing. This “borrowed” depreciation went to facilities which, when closed (and prior to the depreciation transfer), still would have had non-fully depreciated assets. These excess depreciation transfers, which occurred between the third quarter of 2001 and the end of 2002 and totaled nearly \$8 million, enabled the Company to write off assets at closed facilities without a charge against current period income.

189. **Assets at Closed Facilities.** Although HealthSouth closed a number of facilities between 1998 and 2002, assets at those facilities sometimes remained on the Company’s books. As of December 31, 2002, the net book value of assets assigned to a “facility” in the HealthSouth accounting system that reported no revenues was nearly \$62 million.

190. **Lease Accounting.** Two sale-leaseback arrangements entered into in 1999, and a third entered into in 2000, were incorrectly treated as both capital and operating leases. HealthSouth’s general ledger reflected that it owned and was depreciating the leased equipment, which is consistent with a capital lease. Unlike a true capital lease, however, the Company recorded no corresponding lease obligations associated with the leased equipment. Instead, the Company expensed lease payments during the period in which they were incurred, as if the payments had been made under operating leases. Complicating matters further, the Company’s journal entries reflect

that lease payments were made through suspense accounts and thus spread among – and recorded as expenses of – facilities that did not actually use the leased equipment.

191. **Audit Adjustments.** By law or, in the case of partnership or joint venture arrangements, by contract, the financial statements of certain HealthSouth facilities must be audited annually. These “stand alone” audits, *i.e.*, those conducted separately from annual audits of the Company’s consolidated financial statements, at times resulted in proposed adjustments to a facility’s financial statements. E&Y, the independent outside auditor of HealthSouth’s consolidated financial statements, also was engaged to perform most of the required “stand alone” audits. In certain of those audits, the “stand alone” financial statements reflected the effect of adjustments proposed by E&Y. According to the SARC, however, there was no evidence that such adjustments actually were recorded in the Company’s general ledger or reflected in its consolidated financial statements. The SARC found that the failure to record “stand alone” audit adjustments was not accidental: Listings of proposed adjustments to the consolidated financial statements included a cumulative total of unrecorded prior year adjustments. The Company’s unrecorded audit adjustments totaled nearly \$53 million as of December 31, 2002.

192. **Employee and Other Loans.** HealthSouth failed to take required losses for uncollectible loans receivable despite what the SARC termed “the absence of timely (or in some cases any) repayment.” Such failure was a violation of GAAP, as set forth in SFAS No. 5, ¶¶22-23. The amount of these loans was \$18 million.

193. Due to these accounting improprieties, the Company presented its financial results and statements in a manner that violated GAAP, which are described by the following statements:

(a) The principle that revenue should not be recognized unless it has been both earned and is realizable (FASB Statement of Concepts No. 5, 83-84);

(b) The principle that financial reporting should provide information that is useful to existing and potential investors and creditors and other users in making rational investment, credit and similar decisions (FASB Statement of Concepts No. 1, 34);

(c) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events and circumstances that change resources and claims to those resources (FASB Statement of Concepts No. 1, 40);

(d) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to stockholders for the use of enterprise resources entrusted to it. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general (FASB Statement of Concepts No. 1, 50);

(e) The principle that financial reporting should be reliable in that it represents what it purports to represent (FASB Statement of Concepts No. 2, 58-59);

(f) The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions (FASB Statement of Concepts No. 2, 79); and

(g) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered (FASB Statement of Concepts No. 2, 95, 97).

194. Further, the undisclosed adverse information concealed by defendants during the Class Period is the type of information which, because of SEC regulations, regulations of the national stock exchanges and customary business practice, is expected by investors and securities

analysts to be disclosed and is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed.

### **Former HealthSouth Executives Disclose Facts of Wrongdoing**

195. Senior officials have admitted that they, Scrushy and others participated in this massive scheme to defraud investors. For example, Owens and Smith have admitted that beginning at least in or about 1996, Owens, Scrushy, other HealthSouth senior executives recognized that HealthSouth's financial results were failing to produce sufficient earnings per share to meet or exceed Wall Street earnings expectations. Owens, Smith and Beam admitted that they, Scrushy and others recognized that the earnings shortfall created a substantial risk and that unless HealthSouth's earnings per share were artificially improved, HealthSouth's earnings would fail to meet analyst expectations and the market price of HealthSouth's securities would therefore decline. The value of stock options owned by, and bonuses paid to certain HealthSouth Senior Officers, including Scrushy, depended, in part, on HealthSouth meeting earnings projections.

196. Owens and Smith admitted that he, Scrushy, and others agreed to engage in an illegal scheme to artificially inflate HealthSouth's publicly reported earnings and earnings per share and to falsify reports on HealthSouth's financial condition. Owens and Smith admitted that Scrushy was given monthly and quarterly preliminary reports showing the true and actual financial report. This information was provided so that Scrushy could determine if adjustments needed to be made to those true reports.

197. Owens, Smith and Livesay have admitted that when financial information, which would ordinarily be reflected in monthly and quarterly reports to be made available to the public through SEC filings, was presented to Scrushy, and those reports showed that the Company did not or would not meet Wall Street earnings expectations, Scrushy demanded that the reports be changed to meet or exceed those expectations. Livesay admitted that constant pressure was exerted by



Scrushy and other Senior Officers, including Owens and the then-CFOs (Martin and Owens), for HealthSouth's earnings per share to meet or exceed Wall Street's earnings expectations.

198. Smith and Owens admitted that they and Scrushy issued instructions as to the desired earnings per share number and HealthSouth's accounting staff met to discuss ways to inflate artificially HealthSouth's earnings in order to meet Wall Street earnings expectations. These meetings were known as "family" meetings and the attendees were known as the "family." At the meetings, the "family" members discussed how members of the accounting staff would falsify HealthSouth's books to fill the "gap" or "hole" and meet the desired earnings.

199. Martin admitted that he had repeated discussions with Scrushy regarding the fact that the income statements being provided to the SEC and investing public did not accurately reflect the true revenue of HealthSouth. Scrushy directed Martin to inflate HealthSouth numbers so that they met Wall Street's expectations. Scrushy told Martin and other HealthSouth Senior Officers, including Owens, to "fix the numbers" virtually every month for 24 months. Scrushy told them to "figure it out."

200. Martin admitted that as the CFO of HealthSouth, he signed HealthSouth's Forms 10-Q and 10-K, beginning with the 10-K for 1997 and continuing through the 10-Q for the Third Quarter of 1999 knowing that the financial statements attached to the forms did not fairly present, in all material respects, the financial condition and results of operations at HealthSouth. These documents were also signed by Scrushy.

201. Owens, Smith and Martin admitted that they and others made, and caused to be made, false and fraudulent entries in HealthSouth's books and records for the purpose of artificially inflating HealthSouth's earnings and earnings per share. Methods used for artificially inflating HealthSouth's earnings and earnings per share included falsifying the "contractual adjustment" account and decreasing other expenses. After manipulating the "contractual adjustment" and other

expense accounts to inflate artificially revenue on the Income Statement, corresponding fraudulent adjustments were made to increase assets and decrease liability on HealthSouth's Balance Sheet. Thus, false and fraudulent entries were made to accounts in HealthSouth's books and records including, but not limited to, the: (1) PP&E account; (2) cash account; (3) inventory account; and (4) intangible asset (goodwill) accounts. Each of these accounts was reported in HealthSouth's Balance Sheets. Other accounts either in the Income Statement or on the Balance Sheet, or both, would end up misrepresenting the financial status of HealthSouth. Smith admitted that he and other Senior Officers well knew that there was no justification in fact, or under GAAP, for these fraudulent entries. The cumulative inflations summed to billions of dollars.

202. Livesay admitted that another one of the methods used for artificially inflating HealthSouth's earnings and EPS was over-booking reserves and allocating the purchase price of entities acquired by HealthSouth. Livesay also admitted to the practice of building reserves which could later be used to inflate future earnings and revenue.

203. Brown admitted that beginning at least in 1996, Scrushy, other Senior Officers and members of HealthSouth's accounting staff, including Martin, Owens, Beam, McVay, Smith, Harris, Livesay, Edwards, Valentine, Morgan, Ayers and others, were involved in the scheme to defraud investors by artificially inflating HealthSouth's earnings and earnings per share, making false entries in HealthSouth's books and records, and filing false statements with the SEC.

204. Beam admitted that beginning in or about April 1996 until about October 1997, he and others, including Scrushy, devised a scheme to obtain by means of false and fraudulent pretenses and representations monies, credit and funds owned by and under the custody of AmSouth Bank. As the CFO of HealthSouth, Beam signed numerous Form 10-Qs and 10-Ks that were filed with the SEC. He did so knowing that they did not represent in all material respects the true financial condition of HealthSouth. These documents were also signed by Scrushy.

205. Beam admitted that, when HealthSouth obtained extensions of credit, he and other HealthSouth Senior Officers caused false reports of HealthSouth's financial condition, including its earnings, assets, liabilities, profits, and so forth, to be presented to banks and other lenders. On or about April 18, 1996, HealthSouth entered into an agreement with a syndicate of 32 lenders around the world, which included AmSouth Bank, called the Third Amended and Restated Credit Agreement. It was part of that scheme that the agreement obligated the lenders to extend a line of credit totaling \$1.25 billion to HealthSouth, \$55 million of which AmSouth Bank agreed to loan. The agreement provided that HealthSouth would provide to each lender quarterly and annual financial statements which had been certified as true and accurate.

206. Livesay admitted that in approximately 1998 the fixed asset system was falsely manipulated to inflate earnings. Livesay was aware that every entry listed "AP Summary" was a false and fictitious entry made by his staff. The term "AP Summary" was used to identify the fictitious items entered into the fixed asset system because there was insufficient time to individually describe each false entry.

207. Livesay has admitted that in 1998 the "gap" between HealthSouth's actual earnings and the earnings reported to Wall Street and the SEC had become very large and was growing larger. Management within the Treasury Department at HealthSouth prepared schedules illustrating the growing problems and describing HealthSouth's situation as one of burning through cash. Livesay was aware that the actual profits at HealthSouth during this time were insufficient to cover the income taxes due on the reported income and reported this to his superiors, including Owens and the CFO. HealthSouth had to borrow money from banks and other sources to pay their reported tax liabilities. HealthSouth's pre-tax income was overstated by approximately \$635 million in 1998 and \$440 million in 1997.

208. Livesay admitted that he, Harris, and others instructed HealthSouth's accounting personnel to make the bogus entries to HealthSouth's books. As the financial condition of HealthSouth continued to deteriorate, and the "gap" or "hole" between the reported earnings and the actual earnings increased to higher and higher levels, which Scrushy, Owens and other Senior Officers were unwilling to correct, Livesay expressed his concerns to both his staff and the Senior Officers, including Owens and Martin. When he expressed his concerns to Senior Officers, Livesay was told numerous times that "[t]here is a plan" to fix the "gap." However, as quarter by quarter passed, no plan materialized. Livesay was told, "[j]ust one more quarter" or "one more deal."

209. Livesay admitted that he participated in the preparation of HealthSouth's 1998 quarterly and annual reports that were filed with the SEC, including HealthSouth's March 31, 1998 10-Q filed on May 15, 1998; the June 30, 1998 10-Q filed on August 14, 1998; the September 30, 1998 10-Q filed on November 16, 1998; and the December 31, 1998 10-Q filed on March 31, 1999. Livesay, Owens, Smith and other senior officials caused HealthSouth to file these reports publicly with the SEC knowing that the reports materially misstated, among other things, HealthSouth's net income, revenue and earnings per share, assets, and liabilities. As a result of the scheme, HealthSouth's revenue and earnings were inflated by billions of dollars on publicly filed reports.

210. Harris admitted that, beginning in 1999, Harris, in or about the third week of the last month of each fiscal quarter, was required to provide monthly quarterly preliminary reports showing HealthSouth's true and correct financial results to Martin and Scrushy. Sometime prior to 1999, in the course of providing this information, he learned that HealthSouth's financial results were failing to produce sufficient earnings per share to meet or exceed Wall Street's earnings expectations.

211. Harris admitted that when financial information, which would ordinarily be reflected in monthly and quarterly reports made available to the public through SEC filings, was made available to Scrushy, and that information did not meet the expectations of Wall Street, Scrushy

would instruct Harris and others to fix the numbers so that they would meet or exceed Wall Street's expectations. Harris, acting on instructions from certain senior officials at HealthSouth, instructed the accounting staff to manipulate certain accounts on HealthSouth's books and records to accomplish that purpose.

212. Harris admitted that he and certain other HealthSouth senior officials caused HealthSouth to file publicly with the SEC annual reports and quarterly reports that materially misstated, among other things, HealthSouth's net income, revenue, earnings per share assets and liabilities from at least 1999 until 2003.

213. Smith, Owens and Harris admitted that around August 2002, they and Scrushy agreed that Smith would sign and cause to be filed with the SEC a statement certifying HealthSouth's 10-Q for the Second Quarter of 2002 when they knew that the 10-Q contained materially false and misleading information. The Form 10-Q for the Second Quarter of 2002 was signed by Scrushy and Smith, who also knew that the periodic report attached to the 1350 statement on HealthSouth's Second Quarter 10-Q contained materially false information.

214. McVay admitted that shortly after becoming CFO in August 2002, he was told that revenue had been materially overstated in prior quarters, and that cash was materially overstated on the Balance Sheet. McVay understood that these fraudulent entries had been made to artificially inflate earnings and earnings per share.

215. McVay admitted that in November 2002, he signed HealthSouth's Form 10-Q for the Third Quarter of 2002, knowing that it was false and misleading. Before and after the signing of this Form 10-Q, McVay had conversations with Scrushy regarding the overstatement of cash on HealthSouth's Balance Sheet. McVay has stated that Scrushy was aware that he was signing the document with knowledge that prior numbers were incorrect. McVay's discussions with Scrushy centered around the fact that the cash on the balance sheet was higher than what in actuality was the

amount of cash. McVay also stated that Scrushy told him that all companies play games with accounting. McVay admitted that the disparity between HealthSouth's reported cash shown on the balance sheet and actual cash was between \$200 and \$400 million. McVay stated that Scrushy fully understood the level of discrepancy.

216. Hicks admitted that the false entries on HealthSouth's books and accounts caused the quarterly and annual financial statements, the Form 10-Ks and 10-Qs, filed with the SEC for the years from before 1996 through 2002, to be materially false.

217. In late 2000, he learned that the value of HealthSouth's investment in a privately held company which operated senior residential assisted living facilities would be substantially impaired unless HealthSouth participated in an additional round of financing being offered by the privately held company. At the end of 2000, Hicks informed Scrushy and another Senior Officer that the value of HealthSouth's assisted living facility investment, which HealthSouth carried on its books at \$13 million, should be written-off or its value would be substantially impaired unless HealthSouth participated in the additional round of financing.

218. In 2001, Hicks learned that HealthSouth would not participate in the additional round of financing being offered by the privately held company and that, as a result, the assisted living facility investment was substantially worthless. Hicks advised another Senior Officer at HealthSouth that the Company was required to write down the value of the assisted living facility investment. The officer told Hicks that HealthSouth would not write down the value of the assisted living facility investment and that the Company would continue to represent the investment on its books as worth \$13 million.

219. Fowler, HealthSouth's Cash Manager between 1994 and 2003, has admitted that false entries caused the quarterly and annual financial statements filed by HealthSouth with the SEC from 1996 through 2002, to be materially false.

220. Fowler admitted that in 2001, HealthSouth sold approximately \$27 million in the stock of another publicly traded company which was held in HealthSouth's investment portfolio. The Senior Officers failed to and did not record the stock sale on HealthSouth's books. Thus, at year end 2001, HealthSouth's books and records fraudulently represented that the stock was an asset in HealthSouth's investment portfolio, even though the stock had been sold. HealthSouth's Form 10-K for the year ended December 31, 2001, which was filed with the SEC included in the line item for other assets more than \$27 million in the stock of the publicly traded company, when, in truth and fact, HealthSouth had sold that stock in 2001.

221. Smith admitted that from at least 1999 until the present, HealthSouth's financial reports filed with the SEC annual reports and quarterly reports contained false and misleading information on HealthSouth's net income, revenue earnings per share and assets and liabilities. Owens, Smith and Harris admitted the balance sheet included in HealthSouth's Form 10-Q for the Second Quarter of 2002 overstated PP&E by approximately \$1 billion, or approximately 33% of total PP&E reports. The amount of cash on the same 10-Q was overstated by more than \$300 million, and HealthSouth's total assets were overstated by approximately \$1.5 billion.

222. Morgan, Ayers, Edwards and Valentine each admitted to making false entries in HealthSouth's books and records at the direction of Owens, Smith and Harris for the purpose of artificially inflating its revenues and earnings and artificially inflating the value of its assets. Each admitted to knowingly generating records and reports to back out false entries they had made in other records, manufacturing false documents and changing codes on accounts.

223. Edwards stated that she also participated in falsifying the asset records on the balance sheets and on asset listing. She was told that a debit would be made to the asset accounts, that it was temporary, and not to worry about it. Edwards admitted that two years later the temporariness was still there, and the balances were inflated regularly.

224. Ayers stated that she made entries into the financial statements for HealthSouth which inflated assets on the balance sheet. In 2001, she came to understand, because of the regularity of the entries, that they were not temporary, as she had originally been told, and that they were false. After expressing displeasure and asking not to participate any longer, she continued to engage in the fraudulent scheme to inflate HealthSouth's earnings.

225. Valentine stated that at the direction of her superiors, primarily Emery Harris, and more recently, Angela Ayers, she made fraudulent entries into the accounting system, at first without knowing that they were fraudulent. Eventually, she came to realize that they were fraudulent. And they were not stopped, they continued to be made every quarter.

226. Brown has stated that he was instructed by others to create a bogus document showing the sale of stock of another publicly traded company owned by HealthSouth in 2002 when he and other Senior Officers well knew the stock had been sold for more than \$27 million in 2001. In meetings with other Senior Officers, Brown discussed steps that would have to be taken to make the bogus stock sale document appear legitimate. Brown was instructed to have the phony document show that the stock was sold in small blocks over a period of several weeks. This would be done to ensure that the number of shares shown on the bogus document as sold on a particular day in 2002 did not exceed the actual volume of stock in the Company that traded on that day. Further, in creating the bogus stock sale document, Brown would confirm the stock's actual trading price on the dates in 2002 when the bogus sales would purportedly take place. Finally, Brown and others would cause actual wire transfers from HealthSouth's investment account in amounts that were consistent with the purported proceeds of the bogus stock sales.

227. Brown has also admitted that in a meeting which took place near the end of 2002, he met with other Senior Officers of HealthSouth and discussed the fact that HealthSouth's outpatient "same-store volume" had declined significantly in the Third Quarter of 2002 compared to the same



quarter for 2001. At the direction of Scrushy and other Senior Officers, Brown altered the actual same-store volume numbers in HealthSouth's books and records, making it appear that same-store volume for the Third Quarter of 2002 had not declined as much as the actual operating results showed. Brown and others then caused the falsified outpatient same-store volume numbers to be included in a press release.

228. Botts admitted that HealthSouth's tax department would not make original entries into the financial statements. Instead, the tax department would take what the accounting department would do and then report those numbers. HealthSouth's assets were showing up on the Accounts Payable ("AP") Summary on the depreciation schedules that HealthSouth filed with its tangible personal property returns. Botts has stated that Edwards, then HealthSouth's fixed asset clerk, and at a later date, Owens, who was the CFO at the time, told Botts that these were fictitious assets, but to report them anyway. The bogus assets were reported on HealthSouth's Balance Sheet.

229. Diana Henze ("Henze") testified before the E&C Committee on October 16, 2003.<sup>9</sup> In her opening statement, Henze, a former Assistant Controller of HealthSouth, testified that in 1998, after re-running several consolidation processes for one quarter end, she noticed an increase in earnings and earnings per share. She was concerned about the amount and timing of those changes, and approached her supervisor, defendant Livesay, who was HealthSouth's Assistant Controller at the time. Henze testified that Livesay told her that the increase in earnings was the result of the reversal of certain over-reserves and over-accruals. Henze testified that this explanation appeared to be reasonable and she did not pursue the matter further. She also noticed a similar increase in earnings the next quarter, but did not question Livesay about it.

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<sup>9</sup> Henze began working in HealthSouth's accounting department in 1994. In 1997, she was promoted to Assistant Vice President of Finance, and in 1998, was promoted to Vice President of Finance. Her responsibilities included running the accounting computer system, preparing quarterly consolidations and assisting in the preparation of SEC filings.

230. Shortly after returning from maternity leave in March 1999, Henze assisted in preparing the first quarter consolidation and certain financial reports. During that process, she noticed the earnings and earnings per share numbers changing again, and again approached Livesay. Henze testified that she told Livesay, “You can’t tell me that we have enough reserves to reverse that would justify this type of swing in the numbers.” In response, Livesay said that Henze was right. Henze then told Livesay that she did not understand what was going on, but would have no part in any wrong-doing.

231. Shortly thereafter, defendant Owens, who was HealthSouth’s Controller at the time, called Henze regarding the changes in the quarterly earnings and earnings per share figures. Owens said that HealthSouth had to make its numbers or innocent people would lose their jobs and the Company would suffer. Henze testified that she told Owens that she believed that whatever was going on to be fraudulent, and she would not participate in it. She testified that she also asked him “to stop whatever it was they were doing.”

232. The manipulations continued in the second and third quarters of 1999. In October or November of 1999, Henze reported the manipulations to HealthSouth’s Corporate Compliance Department and made an official complaint to Kelly Cullison, who was Vice President of Corporate Compliance. Henze gave Cullison information on her suspicions and where she thought some of the false entries were being made. Henze also provided to Cullison information on how to write specific types of queries against the transactional tables within the system, which helped her look at the manipulated numbers that were being input into the system.

233. Shortly after Henze filed her complaint, Livesay was moved to the position of Chief Information Officer (CIO), and two other individuals were promoted to his previous position of Assistant Controller. Henze confronted Owens about the fact that she had been passed over for

promotion. Owens stated that he could not put Henze in that position, because she would not do what “they wanted me to do.”

234. Kelly Cullison testified before the E&C Committee on October 16, 2003. In her opening statement, Cullison, a former Compliance Director at HealthSouth, testified that in or about November of 1999, Diana Henze reported a possible fraud being committed at HealthSouth, specifically relating to certain accounting transactions. Cullison testified that Henze provided specific information about journal entries being posted on a quarterly basis, and specific queries to run on the computer system to find the journal entries. Ms. Cullison ran the queries and found large dollar amounts being entered, but did not have access to the supporting documents to determine whether or not the journal entries were legitimate, nor did she have the means or authority to properly investigate Henze’s charges.

235. Cullison testified that she took the complaint to her supervisor, defendant Tanner, who expressed concern and said that he would look into the matter. Tanner subsequently told Cullison that the complaint had been resolved and that the matter was closed.

### **The Balanced Budget Act of 1997**

236. Substantially all of HealthSouth’s revenues were derived from private and governmental third-party payors, with some 30% of revenues derived from Medicare, approximately 2.5% from Medicaid, and approximately 65.0% from commercial insurers, managed care plans, workers’ compensation payors and other private pay revenue sources. The inpatient segment accounted for approximately 54% of HealthSouth revenue at the beginning of the Class Period. The inpatient segment – representing over half of HealthSouth’s business – *received over 60% of its revenue from Medicare*. Because of HealthSouth’s dependence on Medicare, changes in Medicare regulations were extremely important to HealthSouth’s business and prospects. The value of its

publicly traded securities was dependent not only on its financial results, but on how the market perceived it would be affected by changes in Medicare regulations.

237. In early February 1997, the Clinton Administration proposed cutting Medicare payments by \$100 billion over five years to help balance the federal budget. President Clinton's February 7, 1997 budget included much of the basic approach enacted as the BBA, including such BBA provisions as the zero update, the 15% reduction in capital costs, the elimination of formula-driven overpayments, home health curbs and skilled nursing facilities curbs, all of which applied to HealthSouth.

238. Defendants were very concerned about these legislative developments and lobbied against their adoption. Indeed, During 1997 and 1998, a representative from U.S. Strategies, HealthSouth's lobbyist, gave presentations to HealthSouth's Board. *See* Appendix 5, setting forth the attendance by defendants and other key individuals at selected Board meetings. Defendants knew that the proposed Medicare reform would have a disastrous impact on HealthSouth's business and that if they disclosed the impact of the BBA, the price of HealthSouth common stock would substantially decline.

239. The timing of these changes was significant because, on February 18, 1997, HealthSouth announced that it had agreed to buy Horizon/CMS Healthcare Corp. for the payment of \$961 million in stock and the assumption of \$700 million in debt, its most significant acquisition to date. Notwithstanding HealthSouth's concerns about the BBA, Scrushy stated on February 18, 1997, the following with respect to the BBA:

***But he also said the move [the acquisition of Horizon] would put HealthSouth in the best position to take advantage of anticipated reforms in Medicare, which he said would enable the company to make money for the first time from the government-sponsored health-care plan for the elderly.***

240. The true adverse impact HealthSouth expected from the BBA is demonstrated by the April 10, 1997 testimony of defendant Foster before the Subcommittee on Health of the House Ways and Means Committee. *See* App. 15. Foster stated in relevant part as follows:

- “The President’s Budget imposes on the PPS-exempt sector a disproportionate amount of the budget cuts in the Medicare program.”
- “PPS-exempt providers also treat a higher proportion of Medicare patients than most acute-care hospitals, further limiting the potential for cost-shifting. For example, ***Medicare constitutes 60% of HEALTHSOUTH’s patient mix.***”
- “The President’s proposals would also establish arbitrary floors and ceilings on TEFRA limits. The proposal would establish a floor of 70% of the national average and a ceiling of 150%.”<sup>10</sup>
- “The Administration has proposed to reduce PPS-exempt capital reimbursement by 15%. This is a ***harsh, immediate cut that hits PPS exempt facilities hard.***”

241. Despite HealthSouth’s opposition, the BBA was enacted into law on August 5, 1997. The BBA negatively impacted HealthSouth because, among other things, the legislation reduced hospital capital payments by 15% beginning on October 1, 1997, eliminated Medicare increases for all PPS-exempt hospitals, including HealthSouth, and eliminated formula-driven overpayments for fiscal year 1998 (October 1, 1997 to September 30, 1998). *See* App. 15. This impact was intensified by the fact that HealthSouth’s inpatient rehabilitation facility costs were already extremely cost competitive with a cost per discharge 40% of the industry average. As a result, as Foster admitted in his April testimony, HealthSouth had minimal leeway to offset revenue reductions in the inpatient business with additional cost reductions. Internal information available to management, such as Medicare cost reports and detailed segment information, enabled them to estimate the magnitude of

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<sup>10</sup> Rehabilitation facilities were paid in accordance with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Payments for inpatient operating costs were based on each provider’s Medicare-allowable inpatient costs compared to a facility-specific ceiling. The ceiling equaled the number of Medicare discharges multiplied by a target amount. The target amount, in turn, equaled the provider’s allowable costs per discharge in a base year, trended to the current year by the update factor.

the impact. The BBA resulted in at least an \$88 million reduction in HealthSouth's revenues in 1998 and \$110 million in 1999.

242. HealthSouth was not only negatively impacted by the provisions of the BBA that directly applied to its Medicare business. The BBA caused pricing pressures in HealthSouth's private payor business as well because Medicare was the price benchmark that was used in HealthSouth's managed care contracts. As a result, when the BBA reduced Medicare reimbursement, the pricing in HealthSouth's managed care contracts was automatically reduced. To make matters worse, the BBA also caused premiums over Medicare pricing of commercial contracts to erode. In addition, BBA provisions reducing Medicare fee-for-service revenues subsequently reduced the payments to commercial health plans providing Medicare Risk coverage through a reduction in the Average Adjusted Per Capital Cost (the "AAPCC") that the health plan received from Medicare for each enrolled member. They in turn passed that reduction on to contracted providers such as HealthSouth. In many cases, providers contract with health plans for a percent of the AAPCC and their reimbursement dropped automatically as the AAPCC fell.

243. The negative impact of the BBA on both HealthSouth's Medicare and private payor business is also demonstrated by the sharp decline in asset turnover following the implementation of the BBA.<sup>11</sup> The fall in asset turnover reflected not only decreasing Medicare reimbursement, but also the pricing pressures of non-Medicare payors responding to the new healthcare environment resulting from the passage of the BBA.

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<sup>11</sup> Asset Turnover is the ratio of revenue to total assets and is a measure of the revenue generating power of the firm's assets. As this falls, a larger amount must be invested in assets to generate the same amount of revenue. It will fall if the revenue derived from a unit of services provided by the assets falls. For the quarters ending between March 1996 and September 1997 (inclusive), asset turnover averaged .75 (every dollar of assets generated 75 cents of revenue on annual basis). For the quarters ending between December 1997 and December 2001, asset turnover averaged .61 (every dollar of assets generated 61 cents of revenue on an annual basis).

244. In addition to causing pricing pressures, the BBA also caused private payors to delay payment to HealthSouth. Shortly after the BBA became effective, HRC's accounts receivable as a percent of revenue began to rise sharply.<sup>12</sup> From December 1997 to September 1998, HealthSouth's ratio of accounts receivable to revenue increased from 87% to 100%. Thus, by the First Quarter of 1998 there was a clear indication that HealthSouth "was seeing delays in payment under current contracts" six months before defendant Scrushy announced it on September 30, 1998.

245. Moreover, contrary to defendants' assertions during the Class Period that HealthSouth's acquisitions would be immediately accretive to earnings, the BBA dramatically lowered reimbursements to merged entities because merged or acquired facilities were considered "new providers" or "new agencies," and the BBA eliminated exemptions for new providers. This payment methodology had a material financial impact on the newly formed agencies created by HealthSouth's acquisition spree.

246. The BBA had an immediate, fundamental, measurable negative impact on key financial parameters of HealthSouth, and HealthSouth's performance did not return to pre-BBA levels. Later, in mid-1998, when HealthSouth revealed it would miss earnings expectations for 1998 and 1999, its stock collapsed to under \$10.00 a share. This miss was, contrary to defendants' prior representations, caused at least in part by the changes affected by the BBA. In fact, HealthSouth later admitted that the BBA materially impacted the company. For example, in February 2000, Scrushy said "We struggled back when we had the introduction of the Balanced Budget Act. ***The company had a little setback for a year or two there, but we have overcome that. The company has started ticking back up.***" And in HealthSouth's 1999 Annual Report to

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<sup>12</sup> Accounts receivable as a percent of revenue is a measure of the changing collectibility of recorded revenue. As accounts receivable as a percentage of revenue increases it can mean slower payments from payers, deteriorating collections or an overstatement of revenue.

Shareholders, HealthSouth admitted that “The Balanced Budget Act of 1997 and managed care cutbacks took a major toll on healthcare providers in 1998 and 1999. We have made many adjustments and *changes we believe will make sure our company continues to grow and prosper in the future....* In 1999, we continued to feel the impact of the Balanced Budget Act of 1997, which sharply reduced incentive payments to cost-effective providers.”

247. The true impact of the BBA on HealthSouth was concealed in part because HealthSouth delayed accounting for the adverse impact of the BBA until the fourth quarter of 1998. In November 1998, over one year after enactment of BBA, HealthSouth took a charge for discontinuing its Home Health business segment in the amount of \$105.3 million. The charge represented the write-down of Home Health assets including goodwill. In addition to the \$105.3 million reduction, \$19.2 million in accounts receivable were deemed to be uncollectible at year-end. The Home Health write-off decreased HealthSouth’s income before minority interests by 37%. Then, in December 1998, 14 months after the effective date of BBA’s Medicare provisions, HealthSouth took an additional charge of \$378.2 million bringing the total asset impairment charge to \$483.5 million for the year. These charges should have been recorded no later than the first quarter of 1998.

248. Defendants also delayed writing off impaired accounts receivables between 1998 and 1999, which inflated HealthSouth’s reported quarterly earnings during 1998 and the first and second quarters of 1999.<sup>13</sup> The belated charges caused a sharp drop in net income in the third quarter 1999

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<sup>13</sup> The provision of doubtful accounts, an expense item on the income statement, is the means by which the accounts receivable is reduced to reflect changing expectations regarding collectability. For the quarters falling between March 1996 and September 1998, the provisions averaged approximately 2.5% of revenue. The year-end provision in 1998 was 4.3% of revenue. During the first three quarters of 1998, the provision averaged \$22.6 million. The provision nearly doubled to \$44.5 million in the fourth quarter of 1998. HealthSouth indicated in the 1998 10-K that \$19.2 million of the additional provision was related to Home Health receivables deemed to be



EPS, far below 1998 prior estimates. This caused an additional drop in HealthSouth's stock price. It was only by virtue of the defendants' accounting fraud, and its overbilling fraud that the Company's results were as favorable as were reported in 1996-1999. It was these same fraudulent practices that permitted defendants to reinflate HealthSouth's stock price in 2000-2002.

### **HealthSouth's Overbilling Fraud**

249. During the Class Period HealthSouth engaged in a scheme to overstate its earnings by miscoding services HealthSouth provided as a Medicare healthcare provider.

250. Prior to the BBA, healthcare providers were reimbursed by Medicare on a cost basis, whereby interim estimated payments were made to providers and reconciled by a cost report submitted at the end of a fiscal year. After the enactment of the BBA, a prospective payment system was gradually implemented, where reimbursement was made to providers after services were provided and claims were submitted to Medicare.

251. HealthSouth was reimbursed using codes known as "CPT" (American Medical Association Current Procedural Terminology) which are nearly universally recognized and utilized by payors of health claims across the nation. Two primary CPT codes have been available since the early 1990s for rehabilitative therapeutic procedures provided to outpatients: Code 97110 for "therapeutic exercise" and Code 97150 for "group therapeutic procedure." Code 97110 pertains to one-on-one therapeutic procedures while 97150 pertains to group activities during which constant attendance is required but one-on-one treatment is not. Code 97110 is billable for every fifteen minutes of one-on-one treatment whereas 97150 is not a timed code. Under CMS rules, a provider

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uncollectible due to the termination of the Home Health segment. According to HealthSouth's 1999 10-K, the provisions for doubtful accounts was \$342.7 million for 1999 compared to \$112.2 million in 1998. Included in the 1999 provision is \$117.8 million recognized in the third quarter and reflecting the charge of accounts receivable of facilities included in the 1998 impairment and restructuring charges. The fourth quarter 1999 provision of doubtful accounts was \$139.8 million.

generally cannot bill for services within the same session under both 97110 and 97150. The value for each CPT code is determined by comparing the value of the resources needed to provide that particular service to the value needed for other services. Group therapy has always been reimbursed at lower rates than individual therapy because it requires less resources from a therapist.

252. Further rules and regulations distinguishing individual and group therapy billing procedures were enacted by CMS' predecessor, the Health Care Financing Administration (the "HCFA"). These regulations, which were published on November 22, 1996 in Vol. 61, No. 227 of the Federal Register (61 FR 59490), stated in relevant part as follows:

We base the work [relative value units] for these services on the expectation that the definition of the codes represents how the services will be furnished when billed to Medicare. For example, we expect that when 15 minutes of a service in the constant attendance category is billed, we may be confident that the provider furnished the 15 minutes of constant one-on-one attendance that is included in the definition of the code. ***If the provider did not furnish 15 minutes of one-on-one constant attendance, as the code is defined, he or she may not bill a code for 15 minutes of constant attendance. If the provider is overseeing the therapy of more than one patient during a period of time, he or she must bill the code for group therapy (CPT code 97150), since he or she is not furnishing constant attendance to a single patient.***

253. Contrary to these regulations, HealthSouth systematically caused its physical therapists and other employees to repeatedly overcharge Medicare for group therapy sessions at the decidedly higher individual therapy rates permitted for under CPT Code 97110. This fraud was compounded by the fact that, in many instances, these therapy sessions were improperly administered by unlicensed therapists or extenders.

### **The *Qui Tam* Actions**

254. HealthSouth has repeatedly miscoded group therapy as individual therapy and billed for unlicensed therapists. This is shown by correspondence from former employees and litigation filed against the Company. Over the past five years, the Company has been a defendant in at least four *qui tam* actions alleging that HealthSouth had improperly overcharged Medicare for therapy services provided to patients at the Company's facilities. The filing of the *Qui Tam* actions, among

other things, should have alerted E&Y to treat HealthSouth as a high-risk audit client. Those actions are as follows:

### **The *Devage* Action**

255. On April 24, 1998, James Devage, a former HealthSouth patient, filed an action in the United States District Court for the Western District of Texas, San Antonio Division, *U.S. ex rel. Devage v. HealthSouth Corp. et al.*, Civil Action No. SA-98-CA-0372 (DWS) (the “*Devage* Action”).

256. In the *Devage* Action, plaintiff alleged, among other unlawful acts, that HealthSouth knowingly and fraudulently overcharged Medicare for:

- individual therapy sessions that were in fact group therapy, under the pertinent billing codes and procedures;
- therapeutic exercises (gym) to develop strength and endurance, range of motion, and flexibility with direct (one-on-one) contact between the patient and the therapist when in fact, one-on-one services were never performed; and
- aquatic therapy with therapeutic exercises with direct contact when in fact one-on-one services were not performed and/or where the service was not medically necessary.

257. In May of 2002, the United States intervened in the *Devage* Action as a plaintiff. The Government complaint alleged that between January 1, 1996 and May 23, 2002, the date of the filing of the Government complaint, HealthSouth improperly submitted claims to Medicare for therapy services provided at outpatient physical therapy facilities without a properly certified plan of care, as required by Medicare regulations. The Government further alleged that HealthSouth improperly billed Medicare for services not provided or for services provided by unqualified or unlicensed personnel.

258. Since early 1995, the Cahaba Government Benefits Administration, a division of Blue Cross Blue Shield of Alabama (“Cahaba”), has served as national fiscal intermediary/carrier for HealthSouth. In this capacity, Cahaba processed most Medicare claims submitted by HealthSouth.

In 1996 and 1997, during a routine analysis of outpatient claims, Cahaba noticed certain aberrations in claims that HealthSouth had submitted to Medicare. Accordingly, Cahaba began a full investigation of HealthSouth's Medicare billing practices.

259. According to the Government, the Cahaba investigation included a review of more than 5,000 Medicare claims for services rendered at 60 HealthSouth outpatient facilities. The consultants who reviewed the records found similar instances of HealthSouth's failure to obtain properly certified plans of care in connection with a substantial percentage of the Medicare claims reviewed, including facilities where the failure to comply with the plan of care requirements was nearly 100%. In addition, Cahaba conducted pre-payment audits of Medicare claims submitted by HealthSouth outpatient physical therapy facilities during 1999. Those audits revealed a similarly high claims denial rate based on HealthSouth's failure to obtain a properly certified plan of care for the physical therapy services rendered to the beneficiary. In fact, from January 1, 1996 until the date the Government complaint was filed in May 2002, HealthSouth routinely sought reimbursement for outpatient physical therapy services provided in the absence of a certified or recertified plan of care.

260. The Government also charged HealthSouth with billing for services provided by unqualified personnel. The Medicare program does not pay for physical therapy services provided by supportive personnel, such as physical therapy aides, athletic trainers or student trainees. Nevertheless, in an effort to boost its Medicare claims and revenues, HealthSouth adopted and implemented a corporate policy permitting and encouraging the use of supportive personnel to provide physical therapy services to Medicare beneficiaries. This policy was sometimes referred to as "Team Treatment." Implementation of the "Team Treatment" policy resulted in Medicare claims for reimbursement being systematically submitted by HealthSouth facilities for physical therapy services provided by unqualified supportive personnel in violation of Medicare regulations.

261. On occasion, the “Team” would consist of a physical therapy assistant and supportive personnel. For each member of the “Team,” two or more patients would be given appointments to receive physical therapy at the same or at an overlapping time. HealthSouth submitted a claim for reimbursement for the services provided to the patient notwithstanding the fact that the patient was treated by supportive personnel rather than a physical therapist or physical therapy assistant. Also, the services provided to each patient were billed as if the physical therapist or physical therapy assistant provided direct, one-on-one care.

262. The Government further alleged that the practice of filing for services provided by unqualified personnel occurred throughout HealthSouth facilities nationwide. For example:

- At a HealthSouth outpatient physical therapy clinic in St. Petersburg, Florida supportive personnel often had full patient schedules.
- At a HealthSouth outpatient rehabilitation facility in Des Moines, Iowa, HealthSouth physical therapists were told that it was expected that they would team with one supportive person and together they would see 24 patients in an 8 hour day, billing between \$150-\$200 (or 4 units of direct, one-on-one care) per patient visit. The only way this goal could be met was to have the supportive personnel provide services directly to the patient, and to bill those services as if the physical therapist had provided the care.
- At a HealthSouth outpatient facility in Scottsdale, Arizona, physical therapy was provided to a patient by a certified athletic trainer. HealthSouth submitted Medicare claims for interim payments to Cahaba for the physical therapy as if it had been performed by a physical therapist.
- At a HealthSouth outpatient facility in Glen Burnie, Maryland, on multiple occasions in June 1995, the physical therapy was rendered by a student physical therapist. HealthSouth submitted Medicare claims for interim payments to Cahaba for the physical therapy as if it had been performed by a physical therapist.

263. The Cahaba investigation found similar instances of billings for services provided by supportive personnel in a substantial percentage of cases. Cahaba’s review team observed many instances of supportive personnel rendering physical therapy services to patients during the on-site visits to HealthSouth’s facilities. HealthSouth even routinely sought reimbursement for outpatient physical therapy services which in fact were not provided. For example, after January 1, 1999,

HealthSouth billed for direct care (one-on-one) services when such services were not provided. HealthSouth also systematically billed Medicare for unskilled services that were not reimbursable under Medicare.

### **The *Darling* Action**

264. In February of 2000, John Darling, a former HealthSouth patient, filed an action against HealthSouth in the United States District Court for the Middle District of Florida, Tampa Division, *U.S.A. ex rel. Darling vs. HealthSouth Sports Medicine & Rehabilitation Center of Clearwater LP*, Case No. 8:00-cv-416-T-26B, for improperly billing Medicare for physical therapy (the “*Darling* Action”). The allegations by Mr. Darling, which are based on Darling’s personal experience and similar to those made by Devage, charge that a HealthSouth facility in Clearwater, Florida wrongfully upcoded Darling’s Medicare billings.

265. On February 28, 2002, the Government intervened as a plaintiff in the *Darling* Action with respect to those allegations asserting that HealthSouth “improperly billed government payors for excessive units of one-on-one physical therapy services or for physical therapy services performed by unlicensed personnel.” In addition, the Government gave notice of its intention to assert additional allegations not alleged in the Darling complaint that HealthSouth “improperly billed government payors.”

### **The *Mandel* Action**

266. On or about October 1, 1999, another action alleging similar misconduct was filed in the United States District Court for the Southern District of New York entitled *U.S.A. ex. rel. Mark D. Mandel v. HealthSouth d/b/a HealthSouth Network Services of NY IPA, Inc.*, 99 Civ. 10184 (JSM).

### **The *Manning* Action**

267. On August 18, 1999, an action was filed in this Court entitled *U.S.A. ex. rel. Dewayne Manning v. HealthSouth Corp.*, Civil Action No. CV-99-BE-2150-S (the “*Manning* Action”). In his

complaint, Manning averred that he began employment with HealthSouth as a physical therapist technician in May 1996, and that the Company, among other wrongful acts, billed Government payors for physical therapy services performed by unlicensed personnel at HealthSouth outpatient rehabilitation facilities. On December 27, 2001, the Government intervened in the *Manning Action* and gave notice of its intention to assert additional claims, based upon HealthSouth's practice of "improperly bill[ing] government payors."

### **HealthSouth Employees Complained to Their Supervisors About the Overbilling Fraud**

268. Numerous HealthSouth employees (now former employees) who were integrally involved in the Company's outpatient therapy operations as administrators, supervisors and therapists were aware of HealthSouth's Medicare violations. These employees communicated their concerns that the Company was systematically over billing the Government by improperly billing group therapy sessions as individual sessions. These employees further noted that HealthSouth's nationally used billing program – "HCAP Support Services" – (HealthSouth Clinical Automated Program Number 7) ("HCAP") did not even allow coding for group therapy under CPT Code 97150. Thus, HealthSouth's proprietary billing system made it impossible to properly bill group therapy sessions under CPT Code 97150. Notwithstanding these repeated communications to senior executives at HealthSouth, the Company continued to systemically upcode and overcharge the Government by, among other improper acts, billing group therapy sessions as individual sessions.

269. Congressional testimony further demonstrates defendants' overbilling. Steve Schlatter<sup>14</sup> testified before the E&C Committee on October 16, 2003, that in April 2001, he became aware of HCFA transmittal 1828 which discussed the use of CPT Code 97150 group therapy. The

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<sup>14</sup> Schlatter, a physical therapist from Muncie, Indiana, was an administrator of a HealthSouth outpatient clinic from July 1995 to December 2001.

transmittal states that this code must be used when a therapist performs “procedures with two or more individuals concurrently or during the same time period.” Schlatter’s concerns were twofold, as this was a common practice within the HealthSouth system and the fact that HealthSouth’s HCAP system (an automated documentation system) did not make this billing code available for clinicians to use. Mr. Schlatter had concerns for his professional staff and his practice. Accordingly, he requested a corporate explanation to ensure compliance with all regulations and that they were in fact treating ethically and within the accepted professional standards. A description of Schlatter’s correspondence regarding these issues is found in Appendix 13.

270. Schlatter initially requested a written policy from HealthSouth. Schlatter also discussed the issue with the American Physical Therapy Association Department of Government Affairs and received the same interpretation of the transmittal. He also discussed this issue with a colleague who had hired an independent firm to perform a Medicare compliance audit on his private physical therapy practice. He claimed his auditors were adamant that group therapy charges must be used when treating more than one patient at a time.

271. Schlatter communicated this information to HealthSouth management via a series of e-mails set forth in the Appendix 13.

272. After nearly two months, Schlatter was told by several colleagues that HealthSouth personnel in the Columbus, Ohio business office were irritated with his persistence in this matter. At that time, Schlatter made appropriate internal adjustments within his own clinic to make sure that they were not treating patients concurrently, which he felt to be the most ethical and professionally accepted standard of practice.

273. In August of 2002, Schlatter read that HealthSouth was claiming it would miss earnings expectations by \$175 million due to unexpected changes in Medicare reimbursements for



group therapy. At that time, Schlatter felt compelled to share his information with the appropriate authorities, thus bringing him before the House Committee.

274. Schlatter questioned the propriety of HealthSouth's practice of billing group therapy as individual therapy and suggested a change in HealthSouth's billing policies at the corporate level. Schlatter also made internal adjustments at his own practice to prevent improper billing (*i.e.*, he would not provide group therapy services, but only individual therapy to his patients).

275. Schlatter testified that there was no way for a HealthSouth physical therapist to bill group therapy rates. HealthSouth's internal proprietary billing system – known as the “HCAP system” – provided only for individual therapy billing. There were thousands of HealthSouth physical therapists across the country who billed individual therapy rates for group therapy services.

276. Schlatter was pressured by certain HealthSouth officials to not report his concerns to HealthSouth's compliance department. Schlatter was told that HealthSouth “would make his life hell.”

277. In addition, Schlatter was warned that ceasing to utilize HealthSouth's billing practices would impact his bottom line. He was ultimately forced to close his practice for economic reasons, related in part to his refusal to bill group therapy at individual rates.

278. A number of other former employees also witnessed rampant improper upcoding by the HealthSouth employees at clinics located throughout the United States. Again, group physical therapy sessions were improperly upcoded and charged to Medicare as if the sessions had involved individual treatment. For example, there were other upcoding practices at a New Jersey HealthSouth clinic: a HealthSouth employee who lacked any “formal training,” and was not a physical, occupational or speech therapist, was designated as a “job coach.” He would work with seven or eight patients at the same time and do practically nothing – perhaps discuss employment

opportunities, perhaps do a few exercises, and would bill for each patient as if individual therapy had been performed.

279. Management at HealthSouth's corporate headquarters asked for guidance as to whether a Florida facility was correctly billing as individual sessions therapy that should be billed under the group therapy CPT Code. Instead of providing its employees with proper guidance on the matter, HealthSouth's executives instructed HealthSouth employees at the Florida facility to continue billing their activities as individual rather than group therapy sessions.

280. A former employee at a HealthSouth rehabilitation hospital in Las Vegas discovered that the Company manipulated billing codes under PPS to boost revenues. Specifically, the former Prospective Payment Systems Specialist was pressured by supervisors to "move up" the codes, *i.e.*, bill a code that receives a higher reimbursement from Medicare.

**Scrushy Knew that HealthSouth Was Improperly Billing Medicare When He Sold His Stock**

281. On January 18, 2002, HealthSouth received notice that the Department of Justice joined a lawsuit by a former employee regarding Medicare regulations over the company's use of "concurrent therapy," the practice of one licensed physical therapist treating more than one patient at a time. Despite this knowledge, Scrushy told investors at the UBS Global Healthcare Services Conference that this is widely practiced in the rehabilitation business and was never before challenged by the Center for Medicare and Medicaid Services. "It's out of line and an attack on the industry," Scrushy said. "They don't have a leg to stand on, so to speak." Scrushy also said the business affected by this case represents only 1 percent of total revenues.

282. On May 9, 2002, HealthSouth announced on the PR Newswire that the Department of Justice had served it with a notice indicating that the Department of Justice was withdrawing its notice of partial intervention in the Manning action. The press release quoted Scrushy:

“As we have said before, the Department appears to be attacking clinically appropriate practices which are consistent with industry standards, and which have not previously been challenged as violations of Medicare regulations. Once again, we strongly deny any suggestion that HEALTHSOUTH has violated the False Claims Act, and we stand ready to defend against these meritless allegations.”

283. The next day, the Associated Press reprinted that:

HealthSouth chief executive Richard Scrushy on Thursday called the government’s move a vindication....

Scrushy said he felt exonerated by the Justice Department’s decision.

“Before they drag companies through the mud like this, they need to get their facts straight,” Scrushy said.

284. On May 14, 2002, defendant Scrushy exercised options to purchase 5,275,360 HealthSouth shares at an exercise price of \$3.7825 per share and sold all of the shares at \$14.05 per share for gross proceeds exceeding \$74 million. The selling price of \$14.05 per share was near the 2002 high price of \$15.90, reached on May 2, 2002. UBS executed the transaction for Scrushy.

285. Also on May 14, 2002, HealthSouth issued a press release disclosing the foregoing stock option exercise and sale of HealthSouth shares by defendant Scrushy, and representing that he had “no intention of selling additional shares in the near future.” Additionally, in addressing the sales during his Investor Day presentation, Scrushy stated that he planned to use the proceeds of the sales to pay down a loan from the Company. The foregoing disclosures were materially false and incomplete because, at the time, defendant Scrushy was negotiating to repay, with additional HealthSouth shares, the \$25 million loan owed to HealthSouth.

**Scrushy Knew that Transmittal 1753 Would Have  
a Material Impact on HealthSouth’s Operations  
Before Selling His Stock to Repay His Loan**

286. After years of clear direction from CMS on how to code and bill for outpatient rehabilitative therapy – Code 97150 for group therapy consisting of two or more individuals, and Code 97110 for individual therapy – on May 17, 2002, CMS issued Transmittal 1753, effective July 1, 2002, which stated:

## GROUP THERAPY SERVICES (CODE 97150)

[P]ay for outpatient physical therapy services (which includes outpatient speech-language pathology services) and outpatient occupational therapy services provided simultaneously to two or more individuals by a practitioner as group therapy services. The individuals can be, but need not be, performing the same activity. The physician or therapist involved in group therapy services must be in constant attendance, but one-on-one patient contact is not required.

Transmittal 1753 was available on the CMS website and widely disseminated within the healthcare industry. Numerous employees of HealthSouth received copies of the transmittal within days of its issuance, including defendant Owens.

287. In issuing Transmittal 1753, CMS emphasized at the time and thereafter, that the Transmittal was merely a reaffirmation of CMS's long-standing rules and regulations regarding group versus individual therapy billing procedures and codes. That view was shared by leading commentators on healthcare billing practices. For example, in its July 5, 2002 edition, *Eli's Rehab Report* (in an article that was circulated among members of HealthSouth senior management) reported as follows:

[1753 is] old news in a new package – it merely “manualizes” information that was already noted in the Federal Register last year....

The American Physical Therapist Association says the transmittal is in accordance with what APTA has been telling its members since the group therapy codes were first added to the Federal Register in 1994.

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[Y]ou need to be careful to bill individual CPT codes only if you are giving a patient one-on-one care. Otherwise you're billing for more time than you worked, which would win you a government audit and fines. If you're the only person in the room, you really shouldn't be walking out with four units of time for one hour [actually worked].

288. Within days of its issuance, numerous senior executives within HealthSouth, including defendant Owens, were considering the impact of Transmittal 1753 on HealthSouth's business and revenues derived from outpatient physical therapy. The issuance of Transmittal 1753 made two things immediately clear: (i) the Company could no longer ignore the plain language of

CPT Codes 97110 and 97150, and (ii) the switch to proper billing practices would have a significant adverse impact on the Company's revenues, profits, costs and margins.

289. On June 6, 2002, Attorney Thomas Fox of Reed Smith sent an e-mail to Horton regarding the pending qui tam litigation against the Company and possible legislative strategy relating to such litigation. Fox stated in part that:

Some strategic decisions need to be made [regarding Transmittal 1753] in the near term on how the company wants to approach these issues. I leave to you the need for decision making at the level of Richard [Scrushy] and/or Bill [Owens], but we want to be certain any legislative approach is fully aired within their [sic] company.

That same day, Horton, attaching the email from Mr. Fox, emailed Owens, Smith, Taylor and Jones-Smith, stating that: "[a]s soon as Bill [Owens] is back in the office, we need to discuss our planned response to the CMS Program Transmittal provision on Group Therapy described below. This is quite important." By email Horton reiterated to Owens, Smith, Taylor and Jones-Smith on June 15, 2002 that, "CMS has put out a program transmittal directing intermediaries to pay for any PT or OT services provided to two or more individuals as group therapy, even if the patients are performing different activities."

290. On June 26, 2002, Horton emailed Jones and stated his belief that 'anything that is paid under Part B (incl. CORFs and rehab agencies) is covered by the new policy. Bill [Owens] and Weston [Smith] agree. ... I have recommended to Bill [Owens] that [the Company] proceed to modify [its] policies, and he agreed."

291. HealthSouth management was aware of the impact of 1753, as reflected in an e-mail by Rick Schmitt on June 26, 2002 to other HealthSouth employees that stated: "[s]enior management has determined the new group code requirements that we have been discussing the past few days applies to us both in Part A and Part B as well as inpatient outpatient."

292. On June 28, 2002, Dr. McKinney responded by email to Ms. Jones's request of June 26, 2002 for verification and stated that "transmittal [1753] was a clarification on [CPT code] 97150

for independent practitioners (MDs who perform the service or Independent PTs [physical therapists]). The definition of 97150 as per the CPT manual is applicable to all providers of this service.” On the same day, Horton sent an e-mail to Jones, Owens, Weston Smith, Foster and others stating that: “This, I think, is the point that I was afraid of. What McKinney is saying can be construed as meaning that this is just clarifying for physicians what everybody else should already know.”

293. At the end of June 2002, Owens directed that all billing for therapy services in HealthSouth’s ambulatory division be suspended until the Company could determine the applicability of Transmittal 1753. At or around this time, Owens believed that CMS may take the position that Transmittal 1753 applied to the physical therapy services HealthSouth provides in its CORFs and rehabilitation agencies, which are included in the Company’s Ambulatory Services Division.

294. On or about June 30, 2002, Scrushy informed Brandon Hale of his willingness to repay the Loan prior to its maturity date of September 20, 2006. In the first week of July 2002, Scrushy informed Owens and Horton of his willingness to repay the Loan, and asked Horton to effectuate the repayment. In mid-July 2002, Horton advised Scrushy that the Corporate Compensation Committee would need to approve the Loan Repayment, and he scheduled such a meeting for July 25, 2002.

295. In a letter dated July 5, 2002, in the context of the pending *qui tam* litigation against the Company, and possible legislative strategy relating to such litigation, Mr. Fox informed HealthSouth that “the definition of Group Therapy to be effective July 1, 2002, would also apply to [HealthSouth’s] hospital outpatient billings,” and that “if HealthSouth were to continue to utilize the clinical standards followed in the past, which essentially limited billing under the Group Therapy Code only when two or more patients were treated at the same time with the same modality, the risk

of liability for claims submitted by HealthSouth for services provided after July 1, 2002 is greatly increased, and could implicate [the Company's] rehab[ilitation] hospitals."

296. On July 7, 2002, Horton forwarded Fox's July 5, 2002 letter to Owens, Smith and Jones, and stated that he agreed with "Reed Smith's strong advice... that the recent group therapy transmittal should be read to apply to any non-PPS PT [Physical Therapy] or OT [Occupational Therapy] services." Horton further stated that he did "not believe what we have gotten from [Blue Cross/Blue Shield of Alabama] is inconsistent with that or particularly helpful to us."

297. On July 8, 2002, at a Monday Morning Meeting, Jones addressed eight items including that she was "[w]orking with BCBS[-]AL on interpretation of various [M]edicare regulations [T]ransmittal 1753 pertaining to Group Therapy). Steve Speil is arranging a meeting with CMS for us to discuss the various interpretations."

298. On July 24, 2002, Horton sent an e-mail to members of HealthSouth's Compensation Committee, i.e., Striplin, Watkins and Chamberlin, and to Brandon Hale and advised them that "[l]ast month, Richard [Scrushy] paid the accrued interest on the loan and indicated that he wanted to satisfy the principal amount by transferring to the company shares with a value equal to the principal amount.... Because the Plan does not expressly provide for this method of repayment, the Compensation Committee needs to ratify this transaction."

299. On July 25, 2002, Rick Schmitt communicated to certain HealthSouth personnel that, based on an extensive review by the Company, it had been determined that the billing code for group therapy must be used when billing Medicare if a therapist supervises more than one patient at a time.

300. On July 26, 2002, Christopher Arrigo, MS, PT, National Director of Clinical Services, emailed to Owens, Horton, and Taylor a document entitled "Clinical Consideration and Implications of Group Therapy Coding in the Medicare Population," which addressed the application of Transmittal 1753 to concurrent physical therapy furnished by the Company to Medicare patients.

301. On July 31, 2002, the Compensation Committee of the Board (directors Striplin, Watkins and Chamberlin) approved the repurchase of shares from Scrushy to repay the principal of the Loan effective July 31, 2002 at a share price established by using an average between the high and low trade price on July 31, 2002. Hale and Horton also were present. Neither the Company nor the Corporate Compensation Committee obtained a fairness opinion for the terms of the Loan repayment, which may have been required pursuant to certain of the Company's debt instruments. The Loan repayment was approved by the Corporate Compensation Committee at a share price of \$10.06 – the average of the high and low trading price on July 31, 2002 – the highest price at which HealthSouth stock had traded in three weeks. The next day, Scrushy transferred 2,506,770 shares of his HealthSouth common stock to HealthSouth in payment of the \$25,218,115 principal amount of the Loan.

302. On August 8, 2002, at a regularly scheduled Board of Directors meeting, Scrushy informed the Board of Transmittal 1753, and stated that it “appeared to change regulations for payment of group and concurrent therapy for outpatient Medicare reimbursement.”

303. McGahan, Roderick O'Neill, Scott Wollard and Hugh O'Hare of UBS attended the August 8, 2002 Board Meeting. *See App. 5.* McGahan presented a detailed analysis of a strategic plan to deal with Transmittal 1753 by spinning or splitting the surgery division (Project Crimson). Scrushy lead the Board through an evaluation of the surgery center business and discussed a possible strategy for spinning out or splitting off the surgery division. Scrushy presented to the Board a proposed management structure for the surgery company and identified individuals for all key executive positions.

304. 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, lead 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 or split-off of the surgery centers (with or without IPO) and the sale of the diagnostic facilities. UBS Warburg then presented to the Board a debt analysis and discussed how the current debt profile impacted the alternatives being considered. McGahan and the UBS Warburg team presented a summary of the timeline of events to take place and led a discussion of the key separation decisions that HealthSouth would need to make.

305. The August 26, 2002 Board Minutes reflect that Owens reviewed the timeline of events resulting from Transmittal 1753, stating that Transmittal 1753 was posted to Part B carriers on May 17, 2002, and that HealthSouth received a copy of the Transmittal from a third party in early June. Scrushy and Owens advised the Board that the estimated impact on revenue of Transmittal 1753 would be \$175,000,000 per year, and that the Corporation would be putting out a press release disclosing this on Tuesday, August 27.

#### **The August 27 Press Release Causes HealthSouth Shares to Plunge in Price**

306. On August 27, 2002, prior to the commencement of trading in HealthSouth shares, the Company announced that it was reducing its earnings guidance by \$175 million annually, and discontinuing and disavowing the earnings guidance it had previously given to investors for 2002 and 2003. In an effort to distract attention from the real causes of this development – the Company’s financial fraud, the Overbilling Fraud, and other fraudulent practices – defendants simply claimed (albeit falsely) that the downturn was due to the recent “changes” in the Medicare rules on outpatient individual and group therapy billing set forth in Transmittal 1753.

307. The Company also tried to divert shareholder attention from the adverse developments by announcing the proposed separation of its Surgery Center Division into a new public company, and changes in senior management, with defendant Scrushy serving as Chairman of

the Board of the new surgery center company; defendant Owens becoming Chief Executive Officer of HealthSouth; defendant Smith assuming responsibility for implementing the proposed transaction; and defendant McVay, then HealthSouth Executive Vice President and Treasurer, becoming Chief Financial Officer of HealthSouth. Additionally, HealthSouth announced that it had hired UBS to assist “in evaluating potential divestitures and other strategies.” The August 27, 2002 press release stated in part as follows:

The company indicated that it was moving forward with the separation plan at this time in part because of unfavorable developments in outpatient therapy reimbursement. Effective July 1, the Centers for Medicare and Medicaid Services (“CMS”) issued a directive to Medicare Part B carriers requiring that outpatient therapy services provided to two or more patients in a single time period be paid for under the “group therapy” payment code, regardless of whether such patients were engaged in the same activity. ***This directive***, which significantly lowers reimbursement for services previously paid as individual therapy, ***is inconsistent with many providers’ understanding of appropriate coding practice***, which looks to the nature of the services provided and the clinical judgment of the therapist to determine whether the group code or individual codes are appropriate.

***Because this program transmittal*** was not directed to Medicare providers or to Medicare Part A fiscal intermediaries, who administer payments under Part B to rehabilitation agencies such as those typically operated by HEALTHSOUTH, and because it ***appears to conflict with other statements by CMS and practices followed in the therapy industry, there has been substantial confusion regarding the impact and applicability of the directive***. HEALTHSOUTH sought clarification through several meetings with its national Medicare intermediary and CMS officials in July and August and continued to receive somewhat conflicting guidance. However, pending further clarification, the company has implemented policies and procedures designed to reflect a conservative interpretation of current Medicare coding requirements in light of the recent directive. Management believes that, over time, it will be able to adjust scheduling and staffing patterns to reduce the negative impact of this new interpretation. However, ***compliance with the conservative policies will adversely impact its revenues and expenses relating to outpatient rehabilitation services in the near term....***

***[T]he company currently believes that the impact of this reimbursement change will require material revisions to its business model and operating strategy in outpatient rehabilitation***. In light of this assessment, and based on available information, the company currently believes that its earnings before interest, taxes, depreciation and amortization will be lower than previously projected by approximately \$175 million annually. Because of the uncertainties surrounding the full impact of these developments at this time, this initial assessment may prove incorrect, and the company is accordingly discontinuing earnings guidance for the remainder of 2002 and 2003 at this time.

308. On the same day, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders. During the call Scrushy and Owens stated:

BILL OWENS: Currently, we believe that this change will result in approximately \$175 million negative impact to EBITDA, and because this assessment is preliminary, we are discontinuing earnings guidance until all of the uncertainties are resolved.

Initiatives on our side – strong cash-flow from in-patient rehab and successful implementation of PPS will allow HealthSouth to make necessary changes in its out-patient rehab operations, while continuing to pay down debt.

\* \* \*

RICHARD SCRUSHY: ... HealthSouth today has great value in it. As you look at all of its assets – and, it may be a knee-jerk reaction here on the minimum of \$175 million reduction in revenue that would fall to the EBITDA line – that's – we believe, is not a long-term issue. We think that we will re-engineer and work through that. You still have a company that's producing well over a billion dollars in EBITDA, has margins in the mid-20's, and will be very strong, in terms of its ability to grow and do all the things that we need to do to continue to create value.

309. Investor reaction to these revelations was immediate and adverse. On August 27, 2002, HealthSouth shares plunged from \$11.97 per share to \$6.71 per share on extraordinarily heavy volume exceeding 42.5 million shares. The following day, August 28, HealthSouth shares declined to \$5.05 per share on volume exceeding 42.1 million shares. Accordingly, HealthSouth shares lost nearly 60 percent of their value in just two days of trading.

310. While defendants attempted to use compliance with Transmittal 1753 as a pretext for the sharp downturn in HealthSouth's expected financial results for 2002 and going forward, knowledgeable government and industry executives disputed defendants' claim that there had been any change in the government's billing practices or procedures. For example, on August 27, 2002, CMS Administrator Tom Scully was quoted by Reuters as follows:

I know those guys well, I'm astounded by (their claims). We made that decision in May and they never called me. If this were such a big problem for them, why am I just hearing about this now?

311. Similarly, Frank Mallon, chief executive of APTA, confirmed in the September 6, 2002 edition of The New York Times that the group-billing rule had been accepted practice for many years: “He said the group-billing rule had been accepted practice by the association since Medicare first announced it in The Federal Register in 1994 and repeated the ruling in 1996.”

312. On August 27, 2002, *The Wall Street Journal* online reported that RehabCare Group, a competitor of HealthSouth which derives 9% of its revenue from outpatient rehabilitation, 30% of which comes from Medicare, was unaffected by the Transmittal 1753. As Alan Henderson, the Chief Financial Officer of RehabCare Group explained: “‘We looked at the interpretation several years ago and changed our practices at that time,’ Henderson said. ‘We don’t do concurrent therapy and bill for it at the individual therapy rates. We bill it as concurrent therapy. It just depends on what’s appropriate.’”

313. On September 19, 2002, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders. During the call Scrushy stated:

Three weeks ago on August the 27th, HealthSouth publicly announced that because of the estimated impact of recent changes in MediCare reimbursement for outpatient therapy announced by the Centers for MediCare and Medicaid Services, CMS, we had reduced our projected EBITDA by about \$175 million annually.

Since then, the Company and I personally have been subjected to inaccurate and misleading press reports, unfounded rumors, and frivolous lawsuits.

Today, we want to turn the lights on and get the facts out.

Before we go further, I would like to emphasize that the Company is in solid financial health, and we continue to lead the industry in providing superior cost-effective clinical outcomes. Even after the estimated impact of the CMS changes, we’re on track to finish the year with EBITDA in excess of \$1 billion.

Our call today is about our response to a new MediCare policy that at least in the near term is likely to have a material impact on operating results and that we believe will also have a detrimental impact on the entire therapy industry and on patient access to care.

\* \* \*

The Company has also engaged the national law firm of Fulbright Jaworski, as special counsel to conduct a review of the issues related to the litigation and other matters. That review process has already begun, and its findings will be presented to the Board and shared with regulatory authorities.

\* \* \*

Now, these are the facts – I sold stock on May 14th after exercising options that I held for 10 year, that were about to expire. There was no reason to let those options expire. For reference, this sale occurred several days before the date of Transmittal 1753, which was directed only to MediCare Part B carriers to advise them of the new MediCare policy on group therapy and more than three months before we had reason to believe that Transmittal 1753 might have a material impact on HealthSouth. With regard to the second transaction on September 9th, 1999, I borrowed money from the Company to buy stock under a plan approved by a vote of our entire stockholders. All our shareholders voted on that. That loan was not due to be repaid under the terms of our stockholder-approved plan until September 2006.

This year, however, given the market sentiment against loans to executives, a lot of pressure we had from shareholders that called, pressure we had from analysts, and even our Board members, we started discussing ways that we might be able to get all those loans paid back, because we felt that was the right thing to do. No interest of dumping big blocks of stock on the market. The Company had announced a stock buy-back program. We have been buying stock back. We're buying stock back today. We announced that. We've been actively purchasing the Company stock.

Now, I agreed that if the Compensation Committee approved it, I would transfer the stock back to the company that would satisfy the loan, letting the Company acquire that block of stock in a buy-back program without incurring any transaction costs or commissions. And, then, I paid all the interest in cash that was owed to the Company at that time, around \$4 million.

Now, on July the 31st, the Compensation Committee approved that transaction and I transferred the stock.

Now, since that time, I continued to exercise options and I've spent over \$4 million in additional cash buying more stock and exercising more options.

Now, these are the facts, and we want you to know them.

But, I think people are missing the fundamentals of the company. I think they're missing the huge cash-flow. They're missing the profitability. The fact – I mean, there are even people that put out stories that the company was insolvent. But, I think if you look and you see a company that has over a billion dollars a year in EBITDA and the highest operating margins in this industry, and – last quarter we paid debt down, and we continue to pay debt down, we've been buying debt back – I mean, we've just been very strong.

So, we're here today to try and clarify that, when we knew it, what we knew, and what the situation is. As soon as we found out about this rule, we put it into play, in

the same quarter that we found out about it. There's no restated of earnings here. There's nothing going back. We're talking about an issue here that we found out about, we immediately corrected it, and we put it into our numbers – and, even after you take the \$175 out, you have a very profitable company that is extremely strong and has an incredible value, if you look at the current stock price.

### **HealthSouth's Document Destruction**

314. Gordon, as chairman of the Compliance Committee, had the authority to retain counsel to investigate allegations that Scrushy knew about the effect of Transmittal 1753 prior to Scrushy's May 2002 stock sales. Gordon proposed retaining the law firm of Wilmer Cutler. However, certain Board Members wanted to retain Fulbright & Jaworski. At the Board Meeting on September 18, 2002, Gordon learned for the first time that Fulbright had been working on the matter for three days – two days prior to the time the Compliance Committee retained the firm. Gordon thus admitted that the Compliance Committee ultimately had no say whatsoever about which law firm would conduct the investigation into Scrushy's conduct. Moreover, Gordon questioned the independence of Fulbright in his October 8, 2002, letter to Scrushy, given the firm's retention to defend HealthSouth in the *qui tam* actions. Gordon received no response to his letter. On September 26, 2002, Fulbright attorneys reviewing files in a file room at HealthSouth's headquarters containing files of Hale, McVay, Owens, and Weston Smith on the fifth floor of the Executive Office Tower (the "Executive Level") noticed a large and a small shredder. Each shredder contained shreds in its collection bag (the "September 26th Materials"). When some of the shredded material was examined, such phrases as "mittal 1753" and "175 m" were noted. Some of the shreds appeared to be from e-mail documents. There was no indication of when the documents had been shredded. The Fulbright attorneys removed the contents of each shredder and took custody of them. The aggregate amount of shreds collected from both shredders filled one banker's box.

315. On October 2, 2002, Fulbright attorneys observed a Company employee shredding documents in the Network Services copier room, located in the North Wing of the third floor. Later that day a large bag of shreds was discovered in the same copier room beside a shredder, apparently

awaiting ordinary pick-up by cleaning personnel. The Fulbright attorneys removed the bag from the corporate offices and took custody of it.

### **HealthSouth Falsely Claims Scrushy Is “Cleared”**

316. On October 30, 2002, HealthSouth issued a press release entitled “HEALTHSOUTH Chairman Richard Scrushy Cleared By Outside Investigation Of Advance Knowledge Of Medicare Rule Change Prior To Stock Transactions” which stated:

Richard M. Scrushy, Chairman of the Board of HEALTHSOUTH Corporation, was cleared by an outside investigation conducted by a national law firm of all allegations of inside knowledge concerning the impact of a Medicare reimbursement rule change prior to stock and loan repayment transactions in May and July 2002.

Fulbright & Jaworski L.L.P., a national law firm based in Houston, Texas, concluded that Mr. Scrushy had no knowledge of any Medicare reimbursement rule change or its financial impact on the Company until two months after he sold stock on May 14 due to expiring stock options and a week after he had repaid a stock loan on July 31.

Fulbright reached its findings after concluding an extensive six-week investigation that began on September 18. Fulbright’s outside review involved interviews with over a dozen key HEALTHSOUTH employees and senior managers, members of the Board of Directors, and others outside the Company and included a review of internal Company email, documents, spread sheets, and other types of electronic data contained in approximately 12,900 documents comprising 119,600 pages, which were in turn derived from a search covering approximately 59,000 documents totaling 546,300 pages.

“This thorough outside review conducted by Fulbright & Jaworski puts to rest any question whether Mr. Scrushy had any inkling or knowledge of the Medicare reimbursement rule change or its impact prior to his stock transactions in May and July 2002,” said independent director Robert P. May, chairman of the Board’s Special Corporate Governance Committee and Special Litigation Committee.

The Fulbright Report concluded:

“...Fulbright & Jaworski L.L.P. has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrushy was aware at the time of his option exercise and sale of HEALTHSOUTH common stock on May 14, 2002, of the pending issuance of Transmittal 1753 [the Medicare rule change]. Fulbright & Jaworski L.L.P. also has uncovered no oral interview or written document (including electronic data) that establishes that Mr. Scrushy knew prior to the time of the transfer by Mr. Scrushy of HEALTHSOUTH common stock to HEALTHSOUTH on or about July 31, 2002, in satisfaction of the principal amount

of a loan made to him by HEALTHSOUTH under its 1999 Executive Equity Loan Plan, of: (i) Transmittal 1753 [the Medicare reimbursement rule change]; (ii) the application of Transmittal 1753 [the reimbursement rule change] to the Company's various outpatient therapy services; or (iii) the Transmittal's potential financial effect on the Company."

\* \* \*

"I am pleased by Fulbright's confirmation of the facts and the truth concerning my lack of any knowledge of the Medicare reimbursement rule change prior to my stock transactions," Mr. Scrushy said.

317. The next day, *The Wall Street Journal* published an article with the headline "HealthSouth Says Review Clears Chairman on Trades" which stated:

HealthSouth Corp. said a six-week review by an outside law firm has found that Chairman Richard Scrushy had no knowledge, prior to stock trades earlier this year, of a shift in Medicare policy that prompted the company to issue a profit warning.

\* \* \*

HealthSouth retained Houston law firm Fulbright & Jaworski to conduct the review, to help settle questions about whether Mr. Scrushy acted properly in selling large amounts of company stock during the months before the profit warning. On May 14, Mr. Scrushy exercised options to buy stock and immediately sold the related shares for an indicated profit of \$52 million. Then, on July 31, he traded back shares to HealthSouth to repay a \$25 million company loan.

\* \* \*

HealthSouth said the Fulbright inquiry found Mr. Scrushy had no knowledge of the Medicare rule change or its financial impact until more than two months after he sold stock May 14 and a week after he used stock to repay the loan. Mr. Scrushy has said he first learned of the change when William Owens, then the company's president and chief operating officer and now the company's chief executive, informed him Aug. 6. Mr. Scrushy had been CEO, but relinquished the post Aug. 27.

\* \* \*

HealthSouth declined to make public the full report or a summary, citing the SEC investigation and numerous shareholder lawsuits. The company quoted the report as stating that the firm "uncovered no oral interview or written document [including electronic data] that establishes that Mr. Scrushy" was aware of the pending Medicare change when he sold shares in May. Similarly, the company said the report found no evidence establishing that Mr. Scrushy knew about the change or its "potential financial effect on the company" prior to transferring stock in July to repay the company loan.

\* \* \*



Bert Denton, president of brokerage firm Providence Capital Inc. in New York, which has a stake in HealthSouth, is pushing for more independent directors on HealthSouth's board. Mr. Denton said he thinks the report carries significant weight even though Fulbright was hired by HealthSouth. "This is a reputable law firm that's not going to put themselves in jeopardy for something like this," he said. "So I think it puts at least this one issue to bed."

318. The press release and stories about Fulbright's review were false or misleading. An e-mail dated October 29, 2002 between two Fulbright attorneys commenting on the draft press release stated:

Hal-This is hilarious. Is it a parody or is it for real? A few thoughts and questions:

1. I did not know we had the power to "clear" Richard. In fact our letter says quite the contrary.
2. What is the legal definition of "inkling"? Is it more than a scintilla?
3. Do these idiots realize that two months after May 14 is July 14?
4. Our investigation began on September 24, not September 17, and was essentially completed (except for the supplemental reports) by October 21, a period of four, not six weeks.
5. We did not review 59,000 documents and 546,300 pages. We merely applied our search parameters to those documents and pages. Our report specifically states that we did not examine documents not responsive to the search terms.
6. Our "conclusion" is not stated accurately as it omits the "In view of" clause that "Fulbright & Jaworski L.L.P. has uncovered."
7. There is no way to confirm a person's "absence of knowledge."

319. Even the choice of counsel had been manipulated by Scrushy and his colleagues. On October 8, 2002, Gordon had sent a letter to Scrushy stating:

At a meeting of the board of directors held on September 17, 2002, I gave a report to the board regarding the meeting of the Corporate Compliance Committee and our desired course of action. I suggested that the Committee be authorized to retain Wilmer, Cutler & Pickering to assist in conducting the inquiry. One of the other members of the Committee suggested that Fulbright & Jaworski be engaged, and I stated that I did not have a problem with that firm. However, when a member of that firm joined the board meeting by conference call, we were informed that he had been working on this matter for the preceding two days. He also expressed his preliminary views about the likely positive results of the investigation.

At our most recent board meeting, I learned that the Company had engaged Fulbright & Jaworski to conduct a review and that it was not to be an independent investigation. The purpose of the Committee's recommendation was to conduct an independent investigation, i.e. one outside the control of management. I might add that I understand Fulbright & Jaworski to be an excellent firm with a fine reputation. My concern goes to the independence of the inquiry.

**DEFENDANTS' USE OF THE INTEGRATED PUBLIC OFFERINGS TO  
CARRY OUT THEIR SCHEME – THE INVESTMENT BANKS INVOLVEMENT**

320. As an integral part of defendants' scheme, HealthSouth raised during the Bond Class Period and Stockholder Class Period at least \$3.4 billion from the investing public using offering memoranda, Registration Statements and prospectuses that all defendants knew or should have known were materially false and misleading because those offering documents included or incorporated the Company's fraudulent financial statements and financial information.

321. Indeed, even the offering structure defendants used was designed to, and did, operate as a fraud on the SEC and the investing public. There are two structures available to issuers to raise capital from the investing public. The customary structure is to register the securities with the SEC using the prescribed form of Registration Statement, and, once the Registration Statement is declared effective, to sell the securities to underwriters, which, in turn, sell the securities to the investing public. The other structure requires reliance on a registration exemption provided in the SEC rules. One such 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, using offering memoranda, sell those securities to Qualified Institutional Buyers ("QIBs"), as defined in the Rule. Under Rule 144A, when complied with, a QIB may then hold the securities, or may resell those securities to other QIBs without first registering them.

322. In order to make the purportedly "private" sale more attractive to QIBs, and, therefore, more likely to be successful for the issuer, the 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 exchange. Under the facts set forth in the Exxon Capital Holdings No Action Letter, a QIB may sell the registered security without compliance with the registration or prospectus delivery provisions of the Securities Act. This two-step structure is more burdensome, more expensive and more time consuming than the customary one-step process.

323. Because of the ease of registration, issuers with access to the public capital markets are more likely to use the customary one-step structure to sell securities directly to the investing public. As described in more detail below, issuers that used the “private” structure, in addition to lacking ready access to the public capital markets, typically did so to preserve confidentiality, to avoid the rating process, to issue securities with complicated or unusual terms, to reduce the cost of issuance, to avoid delays associated with registration, or to delay the take-down of funds. In the late 1980s and early 1990s issuers also used registration exemptions to gain expedited access to capital for unanticipated funding requirements. None of these factors applied to HealthSouth.

324. 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, Citi/Salomon, raised for HealthSouth capital from the investing public through a series of registered equity and debt offerings. Specifically, the Company raised capital through its \$13,000,000 initial public offering in September 1986; 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. Then, in March 1998, even though the Company had ready access to the public markets, HealthSouth abruptly changed course. Notwithstanding this substantial track record of successfully raising capital directly from the investing public, however, and without any need to expend the resources necessary to complete the two-step structure, HealthSouth switched to that more expensive and burdensome structure (the “Integrated Public Offerings”).

325. In March 1998, for the first time, defendants raised capital through the two-step process (the “March 1998 Integrated Public Offering”). They repeated that 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”) – to issue a total of eight debt securities (“Notes”) in six offerings (two of those offerings were for two debt instruments). HealthSouth, the Underwriter Defendants, and Individual Underwriter Defendants Lorello and McGahan falsely purported to have structured these two-step transactions in compliance with SEC Rule 144A, and the Exxon Capital Holdings Corporation exchange structure. In actuality, however, the very structure of those two-step offerings was intended to, and, in fact, did operate as a fraud both on the SEC and Bondholder Class Members. These defendants did not use these two-step transactions for any proper purpose, but, instead, employed them as an artifice (i) to avoid the statutorily-required “due diligence” investigations that would have been required of the Underwriter Defendants in connection with a registered public offering of the Notes; (ii) to avoid filing with the SEC the Registration Statements for the transactions, including these defendants’ disclosure documents; (iii) to shield the Underwriter Defendants and Individual Underwriter Defendants from Securities Act liability for their knowing

involvement in HealthSouth's frauds, and (iv) thereby, to deliberately conceal from the SEC, the investing public, plaintiffs and Class Members the nature and extent of HealthSouth's frauds. Because these two-step transactions were conducted for the purpose of avoiding the registration requirements of the Securities Act, and in a deliberate effort to avoid liability under the Securities Act for known violations thereof, Rule 144A and the two-step structure addressed in the SEC's Exxon Capital series of No-Action letters are inapplicable. Accordingly, none of the so-called private placements were exempt from the registration requirements of the Securities Act, and, therefore, those "private placements" and subsequent exchange offers should be considered together as integrated public offerings that, under the Securities Act, required the Underwriter Defendants to conduct full-blown "due diligence" investigations, and to vouch for the accuracy of the disclosure of all material facts regarding the Company and the transactions. As described in more detail below, Rule 144A explicitly provides that the exemption does not apply to circumstances where, as here, deliberate attempts were made to circumvent the registration requirements of, and liability under, the Securities Act.

### **HealthSouth's Integrated Public Offering Scheme**

326. 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") in 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.

327. The Offering Memoranda each included 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. 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 stated 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.

328. The Offering Memoranda also contained information concerning a variety of HealthSouth business and operational matters that, for the reasons described herein, 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

above, 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 above, 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 below, 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 below, 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;

(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 above, 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 above, HealthSouth failed to write-off more than \$500 million in overdue accounts receivable of dubious collectibility.

329. 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.

330. HealthSouth's six Integrated Public Offerings are described below.

#### **The March 1998 Integrated Public Offering**

331. On March 20, 1998, pursuant to an offering memorandum dated March 17, 1998 (the "March 1998 Offering Memorandum"), HealthSouth sold \$500,000,000 of unregistered 3¼% Convertible Subordinate Debentures due 2002 (the "March 1998 Unregistered Notes"). An additional \$67,750,000 principal amount of March 1998 Unregistered Notes was sold on March 31, 1998 to cover underwriters' overallocments (*i.e.*, sales in excess of amounts originally agreed to among the underwriters and HealthSouth). Interest was payable on April 1 and October 1. According to HealthSouth, the net proceeds from the sale of the March 1998 Unregistered Notes were to be used to pay down indebtedness outstanding under HealthSouth's then-existing credit facilities. The March 1998 Unregistered Notes were convertible into HealthSouth's common stock at the option of the holder at a conversion price of \$36½ per share. The Unregistered March 1998 Notes were to mature on April 1, 2003.

332. The March 1998 Offering Memorandum incorporated, *inter alia*, (a) HealthSouth's Annual Report on Form 10-K for the year ended December 31, 1997; and (b) the Company's



quarterly report on Form 10-Q for the period ended March 31, 1998. E&Y issued an unqualified auditor's report, dated February 25, 1998 (except for Note 14, as to which the date was March 20, 1998), on HealthSouth's 1997 consolidated annual financial statements, in which E&Y represented that, based on its audit, which E&Y reportedly was conducted in accordance with GAAS, the financial statements fairly presented the consolidated financial position of the Company, and were prepared in accordance with GAAP.

333. In connection with the initial sale of the March 1998 Unregistered Notes, the Company and the certain Underwriter Defendants executed a purchase agreement dated March 17, 1998 (the "March 1998 Purchase Agreement"). As described in the March 1998 Purchase Agreement, the pertinent Underwriter Defendants which purchased the March 1998 Unregistered Notes (collectively, the "March 1998 Underwriter Defendants") were: Smith Barney, Inc., which purchased \$459,750,000; and Bear Stearns & Co., Inc., Cowen & Company, Credit Suisse First Boston Corp., J.P. Morgan Securities, Inc., Morgan Stanley & Co., Inc., NationsBanc Montgomery Securities, LLC, and PaineWebber, Inc., each of which purchased \$5,750,000.

334. On or about May 8, 1998, pursuant to the registration rights agreement executed in connection with the initial sale of the March 1998 Unregistered Notes (the "March 1998 Registration Rights Agreement"), HealthSouth filed with the SEC a Registration Statement (the "March 1998 Registration Statement") and prospectus (the "March 1998 Prospectus") in order to effect the purported exchange of the March 1998 Unregistered Notes for registered notes with substantially identical terms (the "March 1998 Registered Notes"). The March 1998 Registration Statement, the March 1998 Prospectus, and the March 1998 Offering Memorandum, incorporated, *inter alia*, (a) HealthSouth's Annual Report on Form 10-K for the year ended December 31, 1997; and (b) the Company's quarterly report on Form 10-Q for the period ended March 31, 1998. Pursuant to its

“Consent of Ernst & Young, LLP Independent Auditors,” dated June 1, 1998, which was included as Exhibit 23.1 to the March 1998 Registration Statement, E&Y consented as follows:

We consent to the reference to our firm under the caption “Experts” in the Registration Statement (Form S-3, No. 333-52237) and related Prospectus of HEALTHSOUTH Corporation for the registration of 15,501,707 shares of its common stock and to the incorporation by reference therein of our report dated February 25, 1998, except for Note 14, as to which the date is March 20, 1998, with respect to the consolidated financial statements and schedule of HEALTHSOUTH Corporation included in its Annual Report (Form 10-K) for the year ended December 31, 1997, filed with the Securities and Exchange Commission.

The March 1998 Offering Memoranda, March 1998 Registration Statement, and the March 1998 Prospectus contained materially false and misleading information, as outlined in detail herein.

335. The March 1998 Registration Statement became effective on or about June 3, 1998, at which time HealthSouth conducted an exchange of the March 1998 Unregistered Notes for the March 1998 Registered Notes. The March 1998 Registered Notes, like the March 1998 Unregistered Notes, were to mature on April 1, 2003; however, HealthSouth defaulted, and to this date has failed to pay the principal due on these Notes.

#### **The June 1998 Integrated Public Offerings**

336. On June 22, 1998, pursuant to an offering memorandum dated June 17, 1998 (the “June 1998 Offering Memorandum”), HealthSouth sold \$250,000,000 of unregistered 6 $\frac{7}{8}$ % Senior Notes due 2005 (the “Unregistered 6 $\frac{7}{8}$ % Notes”) and \$250,000,000 of unregistered 7.0% Senior Notes due 2008 (the “Unregistered 7.0% Notes”) (collectively with the Unregistered 6 $\frac{7}{8}$ % Notes, the “June 1998 Unregistered Notes”). Interest was payable on June 15 and December 15. The Unregistered 6 $\frac{7}{8}$ % Notes were to mature on June 15, 2005; the Unregistered 7.0% Notes were to mature on June 15, 2008.

337. The June 1998 Offering Memorandum incorporated, inter alia, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 1997; and (b) the Company’s quarterly reports on Forms 10-Q for the periods ended March 31, 1998 and June 30, 1998. E&Y

issued an unqualified auditor's report, dated February 25, 1998 (except for Note 14, as to which the date was March 20, 1998), on HealthSouth's 1997 consolidated annual financial statements, in which E&Y represented that, based on its audit, which E&Y reportedly was conducted in accordance with GAAS, the financial statements fairly presented the consolidated financial position of the Company, and were prepared in accordance with GAAP.

338. In connection with the initial sale of the June 1998 Unregistered Notes, the Company and certain of the Underwriter Defendants executed a purchase agreement dated June 17, 1998 (the "June 1998 Purchase Agreement"). As described in the June 1998 Purchase Agreement, the pertinent Underwriter Defendants which purchased the June 1998 Unregistered Notes (the "June 1998 Underwriter Defendants") were: Salomon Brothers, Inc., which purchased \$150,000,000; Goldman, Sachs & Co., J.P. Morgan Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., Morgan Stanley & Co., Inc., and NationsBanc Montgomery Securities, LLC, each of which purchased \$47,500,000; and Bear, Stearns & Co., Inc., Credit Suisse First Boston Corporation, Deutsche Bank Securities, Inc., PaineWebber, Inc., and Scotia Capital Markets (USA), Inc., each of which purchased \$22,500,000.

339. According to HealthSouth, the net proceeds from the sale of the June 1998 Unregistered Notes were to be used to pay down indebtedness outstanding under HealthSouth's then-existing credit facilities. That disclosure did not tell the whole story, which was that the June 1998 Underwriter Defendants were selling the June 1998 Unregistered Notes to the investing public in order to be repaid debt HealthSouth owed to them, certain of their affiliates, and that such repayment was being made with the proceeds of debt with higher interest rates. In fact, at the time of the June 1998 Integrated Public Offering, HealthSouth had drawn down \$991,250,000 of its then-available \$1,250,000,000 credit facility, which included the participation of affiliates of June 1998 Underwriter Defendants J.P. Morgan Securities, Inc. and Scotia Capital Markets (USA), Inc.;

HealthSouth's second quarter 1998 Form 10-Q, which was filed on August 14, 1998, after the June 1998 Underwriter Defendants sold the June 1998 Unregistered Notes, disclosed that the \$1,250,000,000 credit agreement had been terminated, and that the amount outstanding on HealthSouth's then-new \$1,750,000,000 credit agreement was \$750,000,000, \$241,250,000 lower than the amount that had been outstanding prior to the sale of the June 1998 Unregistered Notes under the terminated \$1,250,000,000 credit facility. That Form 10-Q also disclosed that the interest rate on the credit facility for the six months ended June 30, 1998 was 5.8%; the interest rates of the June 1998 Unregistered Notes were 6<sup>7</sup>/<sub>8</sub>% and 7%.

340. On or about August 14, 1998, pursuant to the registration rights agreement executed in connection with the initial sale of the June 1998 Unregistered Notes (the "June 1998 Registration Rights Agreement"), HealthSouth filed with the SEC a Registration Statement (the "June 1998 Registration Statement") and a prospectus (the "June 1998 Prospectus") in order to effect the purported exchange of the June 1998 Unregistered Notes for registered notes with substantially identical terms (the "June 1998 Registered Notes"). The June 1998 Registration Statement, the June 1998 Prospectus, and the June 1998 Offering Memorandum incorporated, *inter alia*, (a) HealthSouth's Annual Report on Form 10-K for the year ended December 31, 1997; and (b) the Company's quarterly reports on Forms 10-Q for the periods ended March 31, 1998 and June 30, 1998. Pursuant to its "Consent of Ernst & Young, LLP Independent Auditors," dated September 9, 1998, which was included as Exhibit 23.1 to the June 1998 Registration Statement, E&Y consented as follows:

We consent to the reference to our firm under the caption "Experts" in the Registration Statement (Form S-4 []) and to the incorporation by reference therein of our report dated February 25, 1998, except for Note 14, as to which the date is March 20, 1998, with respect to the consolidated financial statements and schedule of HEALTHSOUTH Corporation included in its Annual Report (Form 10-K) for the year ended December 31, 1997, filed with the Securities and Exchange Commission.

The June 1998 Offering Memorandum, June 1998 Registration Statement, and the June 1998 Prospectus contained materially false and misleading information as outlined in detail herein.

341. The June 1998 Registration Statement became effective on September 14, 1998, at which time HealthSouth conducted an exchange of the June 1998 Unregistered Notes for the June 1998 Registered Notes. The exchange concluded on October 14, 1998.

### **The September 2000 Integrated Public Offering**

342. On September 25, 2000, pursuant to an offering memorandum dated September 20, 2000 (the “September 2000 Offering Memorandum”), HealthSouth sold \$350,000,000 of unregistered 10¾% Senior Subordinated Notes due 2008 (the “September 2000 Unregistered Notes”). Interest was payable on April 1 and October 1. The September 2000 Unregistered Notes were part of HealthSouth’s senior subordinated obligations and, as such, were subordinated to all of HealthSouth’s existing and future senior indebtedness, and also were effectively subordinated to all existing and future liabilities of its subsidiaries and partnerships. The September 2000 Unregistered Notes mature on October 1, 2008.

343. The September 2000 Offering Memorandum incorporated, *inter alia*, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 1999; and (b) the Company’s quarterly reports on Forms 10-Q for the periods ended March 31, 2000 and June 30, 2000. E&Y issued an unqualified auditor’s report, dated March 19, 2000, on HealthSouth’s 1999 consolidated annual financial statements, in which E&Y represented that, based on its audit, which E&Y reportedly was conducted in accordance with GAAS, the financial statements fairly presented the consolidated financial position of the Company, and were prepared in accordance with GAAP.

344. In connection with the initial sale of the September 2000 Unregistered Notes, the Company and certain of the Underwriter Defendants executed a purchase agreement dated September 20, 2000 (the “September 2000 Purchase Agreement”). As described in the September

2000 Purchase Agreement, the pertinent Underwriter Defendants which purchased the September 2000 Unregistered Notes (the “September 2000 Underwriter Defendants”) were: UBS Warburg LLC, which purchased \$148,750,000; Deutsche Bank Securities, Inc., which purchased \$113,750,000; Chase Securities, Inc., which purchased \$70,000,000; and First Union Securities, Inc., which purchased \$17,500,000.

345. According to HealthSouth, the net proceeds from the sale of the September 2000 Unregistered Notes were to be used to redeem HealthSouth’s then-outstanding 9½% Senior Notes, which were not due to mature until April 1, 2001, and to pay down indebtedness outstanding under HealthSouth’s then-existing credit facilities. That disclosure did not tell the whole story, which was (i) that the September 2000 Underwriter Defendants were selling the September 2000 Unregistered Notes to the investing public in order to be repaid debt HealthSouth owed to certain of their affiliates, (ii) that such repayment to the September 2000 Underwriter Defendants was being made with the proceeds of debt with a higher interest rate; and (iii) that the sale of the September 2000 Unregistered Notes was tied to new commercial lending by affiliates of the September 2000 Underwriter Defendants. In fact, at the time of the September 2000 Integrated Public Offering, HealthSouth had in place a fully drawn down \$1,750,000,000 credit facility, which included the participation of September 2000 Underwriter Defendants Deutsche Banc, Chase and First Union; the Company’s 2000 Form 10-K, which was filed on March 30, 2001, after the September 2000 Underwriter Defendants sold the September 2000 Unregistered Notes, disclosed that, as of December 31, 2000, the entire \$250,000,000 of the 9½% Senior Subordinated Notes had been retired, and that the indebtedness under the \$1,750,000,000 credit facility had been reduced to \$1,655,000,000. That Form 10-K also disclosed that HealthSouth’s short-term facility was retired as of October 31, 2000, and was replaced with a new \$400,000,000 short-term facility through UBS AG, the parent company of September 2000 Underwriter Defendant UBS Warburg LLC. According

to HealthSouth's Fiscal 2002 third quarter Form 10-Q, which was filed on November 14, 2000, the Company's effective interest rate for this credit facility as of September 30, 2000 was 6.81%. The interest rate for the September 2000 Unregistered Notes was 10¾%.

346. On or about November 9, 2000, pursuant to the registration rights agreement executed in connection with the initial sale of the September 2000 Unregistered Notes (the "September 2000 Registration Rights Agreement"), HealthSouth filed with the SEC a Registration Statement (the "September 2000 Registration Statement") and prospectus (the "September 2000 Prospectus") in order to effect the purported exchange of the September 2000 Unregistered Notes for registered notes with substantially identical terms (the "September 2000 Registered Notes"). The September 2000 Registration Statement, the September 2000 Prospectus, and the September 2000 Offering Memorandum, incorporated, inter alia, (a) HealthSouth's Annual Report on Form 10-K for the year ended December 31, 1999; and (b) the Company's quarterly reports on Forms 10-Q for the periods ended March 31, 2000 and June 30, 2000. Pursuant to its "Consent of Ernst & Young, LLP Independent Auditors," dated December 11, 2000, which was included as Exhibit 23.1 to the 2000 Registration Statement, E&Y consented as follows:

We consent to the reference to our firm under the caption "Experts" in the Registration Statement (Form S-4[]) and related Prospectus of HEALTHSOUTH Corporation for the registration of and related Prospectus of \$350,000,000 Senior Subordinated Notes and to the incorporation by reference therein of our report dated March 19, 2000, with respect to the consolidated financial statements and schedule of HEALTHSOUTH Corporation included in its Annual Report (Form 10-K) for the year ended December 31, 1999, filed with the Securities and Exchange Commission and its Annual Report to Stockholders, also incorporated by reference therein.

The September 2000 Offering Memorandum, September 2000 Registration Statement, and the September 2000 Prospectus contained materially false and misleading information as outlined in detail herein.

347. The September 2000 Registration Statement became effective on December 15, 2000, at which time HealthSouth conducted an exchange of the September 2000 Unregistered Notes for the September 2000 Unregistered Notes. The exchange concluded on January 24, 2001.

#### **The February 2001 Integrated Public Offering**

348. On February 1, 2001, pursuant to an offering memorandum dated January 25, 2001 (the “February 2001 Offering Memorandum”), HealthSouth sold \$500,000,000 of unregistered 8½% Senior Notes due 2008 (the “February 2001 Unregistered Notes”). Interest was payable on February 1 and August 1. The February 2001 Unregistered Notes were to mature on February 1, 2008.

349. The February 2001 Offering Memorandum incorporated, *inter alia*, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 2000. E&Y issued an unqualified auditor’s report, dated March 6, 2001, on HealthSouth’s 2000 consolidated annual financial statements, in which E&Y represented that, based on its audit, which E&Y stated was conducted in accordance with GAAS, the financial statements fairly presented the consolidated financial position of the Company, and were prepared in accordance with GAAP.

350. In connection with the initial sale of the February 2001 Unregistered Notes, the Company and certain of the Underwriter Defendants executed a purchase agreement dated February 1, 2001 (the “February 2001 Purchase Agreement”). As described in the February 2001 Purchase Agreement, the pertinent Underwriter Defendants which purchased the February 2001 Unregistered Notes (the “February 2001 Underwriter Defendants”) were: UBS Warburg, LLC, which purchased \$187,500,000 of the February 2001 Notes; Deutsche Banc Alex Brown, Inc., which purchased \$84,375,000; Chase Securities Inc., which purchased \$65,625,000; and First Union Securities, Inc. and Scotia Capital (USA), Inc., each of which purchased \$18,750,000.

351. According to HealthSouth, the net proceeds from the sale of the February 2001 Unregistered Notes were to be used to pay down indebtedness outstanding under its credit facilities.



That disclosure did not tell the whole story, which was that the February 2001 Underwriter Defendants were selling the February 2001 Unregistered Notes to the investing public in order to be repaid debt HealthSouth owed to certain of their affiliates, and that such repayment was being made with the proceeds of debt with a higher interest rate. In fact, at the time of the February 2001 Integrated Public Offering, HealthSouth had drawn down \$1,655,000,000 of its \$1,750,000,000 credit facility, which included the participation of affiliates of February 2001 Underwriter Defendants Deutsche Banc, First Union and Scotia Capital; HealthSouth's first quarter 2001 Form 10-Q, filed on May 15, 2001, after the February 2001 Underwriter Defendants sold the February 2001 Unregistered Notes, disclosed that, as of March 31, 2001, there was \$1,354,000,000 outstanding on the credit facility, which was \$301,000,000 less than the amount outstanding before the February 2001 Underwriter Defendants sold the February 2001 Unregistered Notes. The Company's 2000 Form 10-K, which was filed on March 30, 2001, and its first quarter Form 10-Q disclosed that the interest rates on the credit facility were 7.18% and 6.89% as of December 31, 2000 and March 31, 2001, respectively; the interest rate of the February 2001 Unregistered Notes was 8½%.

352. On or about March 30, 2001, pursuant to the registration rights agreement executed in connection with the initial sale of the February 2001 Unregistered Notes (the "February 2001 Registration Rights Agreement"), HealthSouth filed with the SEC a Registration Statement (the "February 2001 Registration Statement") and prospectus (the "February 2001 Prospectus") in order to effect the purported exchange of the February 2001 Unregistered Notes for registered notes with substantially identical terms (the "February 2001 Registered Notes"). The February 2001 Registration Statement, the February 2001 Prospectus, and the February 2001 Offering Memorandum, incorporated, *inter alia*, (a) HealthSouth's Annual Report on Form 10-K for the year ended December 31, 2000. Pursuant to its "Consent of Ernst & Young, LLP Independent Auditors,"

dated March 23, 2001, which was included as Exhibit 23.1 to the February 2001 Registration Statement, E&Y consented as follows:

We consent to the reference to our firm under the caption “Experts” in the Registration Statement (Form S-4, No. 333-\_\_\_\_\_) and related Prospectus of HEALTHSOUTH Corporation for the registration of \$375,000,000 Senior Notes and to the incorporation by reference therein of our report dated March 6, 2001, with respect to the consolidated financial statements and schedule of HEALTHSOUTH Corporation included in its Annual Report (Form 10-K) for the year ended December 31, 2000, filed with the Securities and Exchange Commission and in its Annual Report to Stockholders, also incorporated by reference therein.

The February 2001 Offering Memorandum, February 2001 Registration Statement, and the February 2001 Prospectus contained materially false and misleading information as outlined in detail below.

353. The February 2001 Registration Statement became effective on March 30, 2001, at which time HealthSouth conducted an exchange of the February 2001 Unregistered Notes for the February 2001 Registered Notes. The exchange concluded on May 31, 2001.

#### **The September 2001 Integrated Public Offerings**

354. On September 28, 2001, pursuant to an offering memorandum dated September 24, 2001 (the “September 2001 Offering Memorandum”), HealthSouth sold \$400,000,000 of unregistered 8<sup>3</sup>/<sub>8</sub>% Senior Notes due 2006 (the “Unregistered 8<sup>3</sup>/<sub>8</sub>% Notes”) and \$200,000,000 of unregistered 7<sup>3</sup>/<sub>8</sub>% Senior Notes due 2011 (the “Unregistered 7<sup>3</sup>/<sub>8</sub>% Notes”) (collectively with the Unregistered 8<sup>3</sup>/<sub>8</sub>% Notes, the “September 2001 Unregistered Notes”). Interest was payable on April 1 and October 1. The Unregistered 8<sup>3</sup>/<sub>8</sub>% Notes were due to mature on October 1, 2011; the Unregistered 7<sup>3</sup>/<sub>8</sub>% Notes were due to mature on October 1, 2006.

355. The September 2001 Offering Memoranda incorporated, *inter alia*, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 2000; and (b) the Company’s quarterly reports on Forms 10-Q for the periods ended March 31, 2001, June 30, 2001 and September 30, 2001. E&Y issued an unqualified auditor’s report, dated March 6, 2001, on HealthSouth’s 2000 consolidated annual financial statements, in which E&Y represented that, based

on its audit, which E&Y stated was conducted in accordance with GAAS, the financial statements fairly presented the consolidated financial position of the Company, and were prepared in accordance with GAAP.

356. In connection with the initial sale of the September 2001 Unregistered Notes, the Company and certain of the Underwriter Defendants executed a purchase agreement dated September 28, 2001 (the “September 2001 Purchase Agreement”). As described in the September 2001 Purchase Agreement, the pertinent Underwriter Defendants which purchased the September 2001 Unregistered Notes (the “September 2001 Underwriter Defendants”) were: UBS Warburg LLC, which purchased \$275,000,000; Deutsche Bank Alex. Brown Inc., which purchased \$100,000,000; First Union Securities, Inc. and J.P. Morgan Securities, Inc., each of which purchased \$72,500,000; Lehman Brothers Inc. and Scotia Capital (USA) Inc., each of which purchased \$25,000,000; Jeffries & Company, Inc., which purchased \$11,250,000; and BNY Capital Markets, Inc., Fleet Securities, Inc. and NatCity Investments, Inc., each of which purchased \$6,250,000.

357. According to HealthSouth, the net proceeds from the sale of the September 2001 Unregistered Notes were to be used to pay down indebtedness outstanding under its credit facilities. That disclosure did not tell the whole story, which was that the September 2001 Underwriter Defendants were selling the September 2001 Unregistered Notes to the investing public in order to be repaid debt HealthSouth owed to certain of their affiliates, and that such repayment was being made with the proceeds of debt with higher interest rates. In fact, at the time of the September 2001 Integrated Public Offering, HealthSouth had drawn down \$1,205,000,000 on its \$1,750,000,000 credit facility, which included the participation of affiliates of September 2001 Underwriter Defendants Deutsche Banc, First Union, J.P. Morgan, Scotia Capital, BNY, Fleet and NatCity; the Company’s third quarter 2001 Form 10-Q, which was filed November 13, 2001, after the September 2001 Underwriter Defendants sold the September 2001 Unregistered Notes, disclosed that

HealthSouth had \$613,000,000 outstanding on its credit facility as of September 30, 2001, which was \$592,000,000 less than the amount outstanding prior to the sale of \$600,000,000 of September 2001 Unregistered Notes. Further, according to that same Form 10-Q, the effective interest rate of this credit facility as of September 30, 2001 was 4.19%; the interest rates for the September 2001 Unregistered Notes were 7<sup>3</sup>/<sub>8</sub>% and 8<sup>3</sup>/<sub>8</sub>%.

358. On or about November 19, 2001, pursuant to the registration rights agreement executed in connection with the initial sale of the September 2001 Unregistered Notes (the “September 2001 Registration Rights Agreement”), HealthSouth filed with the SEC a Registration Statement (the “September 2001 Registration Statement”) and prospectus (the “September 2001 Prospectus”) in order to effect the purported exchange of the September 2001 Unregistered Notes for registered notes with substantially identical terms (the “September 2001 Registered Notes”). The September 2001 Registration Statement, the September 2001 Prospectus, and the September 2001 Offering Memorandum, incorporated, *inter alia*, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 2000; and (b) the Company’s quarterly reports on Forms 10-Q for the periods ended March 31, 2001, June 30, 2001 and September 30, 2001. Pursuant to its “Consent of Ernst & Young, LLP Independent Auditors,” dated November 13, 2001, which was included as Exhibit 23.1 to the September 2001 Registration Statement, E&Y consented as follows:

We consent to the reference to our firm under the caption “Experts” in the Registration Statement (Form S-4 [ ]) and related Prospectus of HEALTHSOUTH Corporation for the registration of \$600,000,000 Senior Notes and to the incorporation by reference therein of our report dated March 6, 2001, with respect to the consolidated financial statements and schedule of HEALTHSOUTH Corporation included in its Annual Report (Form 10-K) for the year ended December 31, 2000, filed with the Securities and Exchange Commission and in its Annual Report to Stockholders, also incorporated therein.

The September 2001 Offering Memorandum, September 2001 Registration Statement, and the September 2001 Prospectus contained materially false and misleading information as outlined in detail herein.

359. The September 2001 Registration Statement became effective on November 19, 2001, at which time HealthSouth conducted an exchange of the September 2001 Unregistered Notes for the September 2001 Registered Notes. The exchange concluded on January 17, 2002.

### **The May 2002 Integrated Public Offering**

360. On May 17, 2002, pursuant to an offering memorandum dated May 17, 2002 (the “May 2002 Offering Memorandum”), HealthSouth sold \$1,000,000,000 of unregistered 7<sup>5</sup>/<sub>8</sub>% Senior Notes due 2012 (the “May 2002 Unregistered Notes”). Interest was payable on June 1 and December 1. The May 2002 Unregistered Notes were to mature on June 1, 2012.

361. The May 2002 Offering Memorandum incorporated, inter alia, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 2001; and (b) the Company’s quarterly reports on Forms 10-Q for the periods ended March 31, 2002, June 30, 2002, and September 30, 2002. E&Y issued an unqualified auditor’s report, dated March 12, 2002, on HealthSouth’s 2001 consolidated annual financial statements, in which E&Y represented that, based on its audit, which E&Y stated was conducted in accordance with GAAS, the financial statements fairly presented the consolidated financial position of the Company, and were prepared in accordance with GAAP.

362. In connection with the initial sale of the May 2002 Unregistered Notes, the Company and certain of the Underwriter Defendants executed a purchase agreement dated May 22, 2002 (the “May 2002 Purchase Agreement”). As described in the May 2002 Purchase Agreement, the pertinent Underwriter Defendants which purchased the May 2002 Unregistered Notes (the “May 2002 Underwriter Defendants”) were: UBS Warburg LLC, which purchased \$200,045,139; Deutsche Bank Securities Inc., which purchased \$200,045,138; Banc of America Securities Inc., which purchased \$159,010,238; Scotia Capital (USA) Inc., which purchased \$153,880,876; First Union Securities, Inc., which purchased \$119,001,211; J.P. Morgan Securities, Inc., which

purchased \$88,225,035; Fleet Securities, Inc., which purchased \$33,340,856; Salomon Smith Barney Inc., which purchased \$20,517,450; NatCity Investments, Inc., which purchased \$13,623,587; and Jeffries & Company, Inc., which purchased \$12,310,470.

363. According to HealthSouth, the net proceeds from the sale of the May 2002 Unregistered Notes were to be used to pay down indebtedness under its principal credit agreement and for general corporate purposes, including the reduction of other outstanding indebtedness and similar obligations. That disclosure did not tell the whole story, which was that the May 2002 Underwriter Defendants were selling the May 2002 Unregistered Notes to the investing public in order to be repaid debt HealthSouth owed to certain of their affiliates, and that such repayment was being made with the proceeds of debt with a higher interest rate. In fact, at the time of the May 2002 Integrated Public Offering, HealthSouth had drawn down \$540,000,000 of its 1,750,000,000 credit facility, which included the participation of affiliates of May 2002 Underwriter Defendants Deutsche Banc, BOA, Scotia Capital, First Union, J.P. Morgan, Fleet and NatCity; HealthSouth's second quarter 2002 Form 10-Q, which was filed August 14, 2002, after the May 2002 Underwriter Defendants sold the May 2002 Unregistered Notes, disclosed that the credit facility was repaid in full, and, in fact, that it was terminated effective June 22, 2002. Further, according to the Company's first quarter 2002 Form 10-Q, which was filed on May 10, 2002, the effective interest rate at March 31, 2002 on the credit facility was 2.34%.; the rate of the May 2002 Unregistered Notes was 7<sup>5</sup>/<sub>8</sub>%. In addition, though not disclosed in the May 2002 Offering Memorandum, the May 2002 Prospectus or the May 2002 Registration Statement, HealthSouth used proceeds from the May 2002 Integrated Public Offering to pay taxes on fictitious income.

364. On or about June 28, 2002, pursuant to the registration rights agreement executed in connection with the initial sale of the May 2002 Unregistered Notes (the "May 2002 Registration Rights Agreement"), HealthSouth filed with the SEC a Registration Statement (the "May 2002

Registration Statement”) and prospectus (the “May 2002 Prospectus”) in order to effect the purported exchange of the May 2002 Unregistered Notes for registered notes with substantially identical terms (the “May 2002 Registered Notes”). The May 2002 Registration Statement and the May 2002 Prospectus, as did the May 2002 Offering Memorandum, incorporated, inter alia, (a) HealthSouth’s Annual Report on Form 10-K for the year ended December 31, 2001; and (b) the Company’s quarterly reports on Forms 10-Q for the periods ended March 31, 2002, June 30, 2002 and September 30, 2002. Pursuant to its “Consent of Ernst & Young, LLP Independent Auditors,” dated August 19, 2002, which was included as Exhibit 23.1 to the May 2002 Registration Statement, E&Y consented as follows:

We consent to the reference to our firm under the caption “Experts” in the Registration Statement (Form S-4, No. 333-91508) and related Prospectus of HEALTHSOUTH Corporation for the registration of \$998,000,000 Senior Notes and to the incorporation by reference therein of our report dated March 12, 2002, with respect to the consolidated financial statements and schedule of HEALTHSOUTH Corporation included in its Annual Report (Form 10-K) for the year ended December 31, 2001, filed with the Securities and Exchange Commission.

The May 2002 Offering Memorandum, May 2002 Registration Statement, and the May 2002 Prospectus contained materially false and misleading information as outlined in detail herein.

365. The May 2002 Registration Statement became effective on August 22, 2002, at which time HealthSouth conducted an exchange of the May 2002 Unregistered Notes for the May 2002 Registered Notes. The exchange concluded on September 25, 2002.

**The Underwriter Defendants Are “Underwriters”  
and “Sellers” of the Notes**

366. 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 the materially false and misleading Registration Statements used in connection with the Integrated Public Offerings. The Underwriter Defendants also “offer[ed]” and “s[old],” both as defined in §2(a)(3) of the Securities Act, the Unregistered Notes and the Registered Notes using the materially

false and misleading Offering Memoranda and Prospectuses, and, therefore, are liable as such under §12(a)(2) of the Securities Act, because the Underwriter Defendants, together with Individual Defendants Lorello and McGahan, HealthSouth and certain of the Individual Defendants, jointly designed a scheme to enable the Company to obtain almost \$3.4 billion in financing from the investing public while evading the registration provisions of the Securities Act. Under that scheme, the Underwriter Defendants and HealthSouth conducted the Integrated Public Offerings in which the Underwriter Defendants distributed to investors billions of dollars of Unregistered Notes using Offering Memoranda, Registration Statements and Prospectuses that they knew, or should have known, contained financial statements and financial information that was materially false and misleading.

367. As described in detail below, Lorello and McGahan, as well as Citi/Salomon and, later, UBS, knew about and, indeed, encouraged HealthSouth's financial fraud. Accordingly, Lorello, McGahan and others at Citi/Salomon knew that HealthSouth could not withstand the scrutiny of the statutory underwriter due diligence that another underwritten public offering of registered debt would require. As a result, Lorello, McGahan and Citi/Salomon, together with HealthSouth and certain of the Individual Defendants, devised a scheme to circumvent the due diligence requirements required under, and attempt to evade liability imposed by, the Securities Act. Their eagerness to avoid any involvement with registered debt securities on behalf of HealthSouth was made clear during the November 5, 2003 hearing that the E&C Committee held in connection with the Congressional investigation into the HealthSouth accounting scandal. In the following sworn testimony provided to the Committee, McGahan incorrectly claimed that, even though UBS became aware prior to the effective date of the May 2002 Registration Statement of facts that rendered the May 2002 Registration Statement and the May 2002 Offering Memorandum materially false and misleading, UBS bore no responsibility for the content of the May 2002 Registration



Statement, and no duty to correct the material misstatements in the May 2002 Offering Memorandum that UBS and the other May 2002 Underwriter Defendants used to distribute the May 2002 Unregistered Notes:

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 –

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.

It accordingly is admitted that, during the summer of 2002, UBS knew that the May 2002 Offering Memorandum – the very offering memorandum that UBS and the other May 2002 Underwriter Defendants used to sell the May 2002 Unregistered Notes (which, because the May 2002 Unregistered Notes were not yet exchanged for May 2002 Registered Notes, remained effective at the time UBS learned of the misstatements) – was materially false and misleading. UBS and McGahan have further admitted that it was their duty to update the May 2002 Offering Memorandum. However, UBS, according to McGahan's sworn testimony, never did so, nor did UBS cause the Company to notify the SEC concerning, or to make corrections in the not-yet-effective, May 2002 Registration Statement.

368. To improperly avoid registration of the debt, and, as a result, attempt to evade liability for Citi/Salomon/UBS under the Securities Act, Lorello, McGahan, Citi/Salomon, HealthSouth and others developed a scheme to raise the capital the Company needed, while maintaining the relationship with, and, of course, the flow of fees and other compensation to, Citi/Salomon. The

scheme required the application of the exemption provided by SEC Rule 144A, as clarified in several SEC “No Action” letters, beginning with the SEC’s May 13, 1988 letter concerning Exxon Capital Holdings Corporation. Claiming that they were distributing the Unregistered Notes in compliance with, and in reliance upon, Rule 144A, the Underwriter Defendants – led by Citi/Salomon, and, later, UBS – hoped to continue raising debt capital for HealthSouth through the knowing use of materially false and misleading financial statements and financial information included in and/or incorporated into the Offering Memoranda, while, at the same time avoiding liability either as “underwriters” under §11 of the Securities Act, or as “sellers” under §12 of the Securities Act.

369. However, Rule 144A, as expressly set forth in Preliminary Note 3 to that Rule, does not provide an exemption from registration under the Securities Act, where the transactions are part of a scheme – here, the distribution of the Unregistered Notes and the Registered Notes through the use of materially false and misleading Offering Memoranda, Registration Statements and Prospectuses – to avoid 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.

Without the application of the Rule 144A registration exemption, 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.

370. In addition, the SEC's Exxon Capital No Action letter is 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 that position; all others rely upon the SEC's stated position at their own risk. Lorello, McGahan and Citi/Salomon (and later UBS) never sought the SEC's position with respect to HealthSouth's purported reliance on the Rule 144A exchange structure described on behalf of Exxon Capital. This comes as no surprise for two reasons. First, at the time in 1998 that Lorello and McGahan presented the Rule 144A structure to HealthSouth, they and others at Citi/Salomon knew, or should have known, that the SEC, through what became known as the "Aircraft Carrier Proposal," the substance of which was known in the securities industry prior to the issuance of the formal SEC Release in November 1998, was contemplating the complete elimination of the type of two-step transaction they were using, and, therefore, that the SEC was looking less favorably upon such exemptions. Second, any No Action letter that HealthSouth would have received would have been useless because all No Action letters are restricted to the facts set forth in the letter request. HealthSouth and Citi/Salomon hardly could inform the SEC that, in order to complete what would have been the proposed structure, HealthSouth and the Underwriter Defendants planned to use materially false and misleading offering memoranda.

**HealthSouth and the Underwriter Defendants Improperly Exploited the Rule 144A Exchange Structure in a Scheme Intended to Evade the Registration Requirements of the Securities Act**

371. When it first proposed Rule 144A, the SEC observed that, given the ease of registration, issuers with accessibility to the public markets were more apt to use those markets for financing than issuers without ready access to public markets. The SEC further found that issuers of private debt did so to preserve confidentiality, to avoid the rating process, to issue securities with complicated or unusual terms, to reduce the cost of issuance, to avoid delays associated with registration, or to delay the take-down of funds. Another purpose of private debt offerings in the late

1980s and early 1990s was to gain expedited access to capital for unanticipated funding requirements. What private debt offerings were not used for, and what the SEC did not envision the use of Rule 144A to enable, was raising capital for day-to-day operations that would have and should have been anticipated through the normal budgeting process of a corporation.

372. HealthSouth, as demonstrated by the Company's four public equity offerings and three public debt offerings during the late 1980s and mid-1990s, had ready access to the public debt and equity markets, and did not need to use the private debt market to raise capital. In addition, none of the circumstances identified by the SEC to explain why certain issuers offered private rather than public debt was present when HealthSouth issued debt instruments in purported compliance with, and reliance on, Rule 144A.

373. Based upon the methods employed by HealthSouth to issue its Unregistered Notes – the Company used investment banks as intermediaries to reach as many institutional investors as necessary to purchase the debt, and have its debt rated by Moody's and Standard & Poor's – HealthSouth obviously was not concerned either about maintaining confidentiality or about avoiding the rating process. Also, none of the Unregistered Notes were complicated or unusual; out of the eight separate debt instruments issued, six were for senior notes, one was for senior subordinated notes, and one was for convertible subordinated debentures. HealthSouth did not seek to delay take-down of the funds; on the contrary, the Company immediately used the financing to fund operations or acquisitions, or to replace pre-existing credit facilities or debt.

374. Nor did HealthSouth use Rule 144A and an exchange offer to reduce the costs of issuance. In fact, none of the minutes of the HealthSouth Board meetings that have been made public describes any cost/benefit analysis performed by the Company to support the use of this more complicated structure. At the time HealthSouth was issuing its debt, the costs associated with the two-step Rule 144A structure were as much as, or likely more than, the costs necessary to conduct a

customary registered 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 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.

375. Lastly, HealthSouth could not have been concerned with delays associated with registration. As HealthSouth's 1989 and 1994 public debt offerings demonstrate, the Company was able to obtain financing via the public markets in a reasonably short period of time, and in substantially the same amount of time that it would have taken to obtain financing directly through the public debt market. HealthSouth completed its \$52,000,000 debt offering in 1989 just nineteen days after the initial Registration Statement was filed with the SEC, and the Company completed its

\$115,000,000 debt offering and its \$250,000,000 debt offering in 1994 less than eight weeks after the initial Registration Statement was filed with the SEC. Having established a track record of successfully accessing the public debt market, there was no need to switch to the more complicated and more expensive two-step Rule 144A structure. Indeed, during the time HealthSouth was issuing debt in purported compliance with Rule 144A, other companies with similar debt ratings were issuing registered debt with no more time from inception to funding than it took to complete “private” debt offerings.

376. And even if HealthSouth was able to obtain “private” financing in less time than it could obtain financing through publicly issued debt, HealthSouth did not have any need to expedite that financing and incur additional costs to do so. There is no explanation in any of the Company’s many public filings with the SEC, any press releases, any of the available minutes of meetings of HealthSouth’s Board, or any of the documents Bond Plaintiffs have reviewed in connection with their investigation, as described herein, of any unplanned need for quick financing. Moreover, at the time that HealthSouth switched from the customary one-step public sale structure to the two-step Rule 144A structure, publicly issued debt was being priced in a similar amount of time as investment grade “privately placed” debt like that sold by the Company.

377. HealthSouth did not have any of the concerns normally confronting issuers which were required to avoid the public debt markets, and, in fact, had ready access to the public markets. Nevertheless, HealthSouth spent at least as much money, if not more, to complete a series of Rule 144A exchange offerings that it would have had to have spent to complete public debt offerings just to obtain “private” financing no quicker than the financing the Company would have obtained had HealthSouth conducted public offerings of registered securities. Indeed, any claim that the Company saved costs and delays by avoiding the due diligence investigation cannot be squared with Lorello’s



sworn testimony that his Citi/Salomon/UBS “deal teams” had “conducted extensive due diligence on HealthSouth.” The only explanation for this dramatic change lies with the investment banks.

378. In order to obtain debt financing, whether registered or privately placed, HealthSouth needed investment banks to locate purchasers of the debt securities. Not surprisingly, the only difference between a registered debt offering and a “private” offering under Rule 144A pertains QIBs, like investment banks, that would have resold the debt to other QIBs prior to the debt being registered. Under Rule 144A, any QIB that purchased Unregistered Notes from the Company, and then sold those Unregistered Notes to other QIBs, would be deemed not to have participated in a distribution of those Unregistered Notes, and, therefore, not be an “underwriter” of those securities within the meaning of §§2(11) and 4(1) of the Securities Act.

379. Investment banks regularly underwrite publicly issued debt securities; in fact, certain of the Underwriter Defendants, with Citi/Salomon (under the direction of Lorello and McGahan) in the lead role, had successfully underwritten the Company’s 1989 and 1994 public debt offerings. Nevertheless, the minutes of the March 6, 1998 meeting of HealthSouth’s Board of Directors, which minutes, in heavily redacted form, were made publicly available in connection with the SEC’s motion to freeze Scrushy’s assets, reveal that Individual Underwriter Defendants Lorello and McGahan, then of Smith Barney Inc., presented for the Board’s consideration a proposal for HealthSouth to obtain debt financing through a Rule 144A exchange offering. Where, as here, there is no reasoned basis to switch to a Rule 144A structure after successfully issuing registered debt, the investment banks must have determined that, were they to continue to underwrite publicly issued debt, they would more likely become subject to liability under the Securities Act. That determination only could have resulted from Lorello’s and McGahan’s knowledge of HealthSouth’s financial shenanigans.

**HealthSouth's Relationship with UBS, Citi/Salomon and Lorello and McGahan Compels the Inference that They Knew About and Actively Concealed HealthSouth's Financial Fraud**

380. HealthSouth and many of the Senior Officer Defendants, including Scrushy, Owens and Martin, have had a longstanding and substantial relationship with Defendants Lorello and McGahan, and with Citi/Salomon and UBS. Indeed, in their over sixteen-year relationship with HealthSouth, Lorello, McGahan and others at Citi/Salomon and UBS were intimately involved in all aspects of the Company's operations and finances: (i) they were the lead underwriters in (a) HealthSouth's September 1986 initial public offering; (b) HealthSouth's three secondary public offerings; and (c) HealthSouth's eleven debt financings; (ii) they advised and consulted with the Company in connection with over sixty transactions, and were lead advisors in transactions valued at over \$7.7 billion; (iii) they provided short and long-term commercial financing to the Company; (iv) they financed several of HealthSouth's and Scrushy's investments, including a variety of "off-balance sheet" special purpose ventures; (v) they advised HealthSouth in connection with the Company's aborted 1998 attempt to spin-off its inpatient operating segment, and again in 1999 in connection with "Project Crimson," HealthSouth's aborted attempt to spin-off its surgery center division; (vi) they invited Scrushy to hand-pick Capek as the UBS analyst to cover HealthSouth; (vii) they showcased HealthSouth in analyst reports, and had the Company make presentations at each of UBS's Global Healthcare conferences; (viii) they sponsored non-deal roadshows for the Company; and (ix) they regularly attended HealthSouth Board of Directors' meetings, and made presentations on a variety of core operational matters. All of the transactions led by Citi/Salomon and UBS under the leadership of Lorello and McGahan required Citi/Salomon and UBS, particularly Lorello, McGahan and other members of the Corporate Finance Department in each investment bank, to obtain substantial knowledge about HealthSouth during the course of the due diligence procedures those investment banking professionals were required to complete. Indeed, Lorello

testified under oath at the November 5, 2003 E&C Committee hearing in connection with its investigation into the financial debacle at HealthSouth, that experienced “deal teams conducted extensive due diligence on HealthSouth.” HealthSouth, Scrushy and the HealthSouth Board relied heavily upon Lorello, McGahan and Citi/Salomon and UBS in connection with a variety of core strategic decisions for the Company.

381. Certain UBS documents that plaintiffs obtained without the benefit of discovery and reviewed in connection with their investigation, further illuminate the substantial depth and breadth of the intense relationship Lorello, McGahan and their investment banking colleagues maintained with HealthSouth over the course of more than sixteen years. Those documents also provide insight into the considerable reliance HealthSouth placed on Lorello and McGahan, and just how important the HealthSouth relationship was to Lorello, McGahan, Citi/Salomon and UBS. For example, in 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, UBS 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, based upon Lorello’s and McGahan’s insistence, approved that transaction over concern about risk that UBS may lose money on the trade.

382. Other UBS documents that plaintiffs have reviewed reveal that Lorello and McGahan, as well as Citi/Salomon in its several iterations since 1986, and UBS, once Lorello and McGahan left Citi/Salomon in 1999 to join UBS, were intimately familiar with all aspects of HealthSouth’s business and finances, as Lorello and McGahan, among others at Citi/Salomon and UBS, provided substantial assistance and advice on a myriad of core business and operational issues. In Section 3 of what appears to have been an internal April or May 2002 UBS presentation on selected significant “long term” relationships, UBS described some but not all aspects of its extensive consulting and

finance business with the Company, and stated that “UBS Warburg’s Healthcare team has successfully developed a strong partnership with HealthSouth over the past 16+ years.” For example, Citi/Salomon and UBS (through Lorello and McGahan) helped HealthSouth raise over \$3.8 billion in equity and debt as of the date of that presentation, plus another \$1 billion of debt later in May 2002. In particular, Citi/Salomon and UBS took HealthSouth public in a \$13 million initial public offering in September 1986, followed by three secondary public equity offerings, one in June 1990 (\$57 million), another in May 1991 (\$74 million), and the third in September 1995 (\$350 million), raising for the Company almost \$500 million in equity capital.

383. Lorello, McGahan and UBS (and Citi/Salomon before it) also helped HealthSouth raise over \$3.8 billion in public debt financing in eleven transactions in the thirteen years from May 1989 to May 2002, as follows:

7¾% Convertible Subordinated Debentures (May 1989)	\$ 52,000,000
9½% Senior Subordinated Notes (March 1994)	250,000,000
5% Convertible Subordinated Debentures (March 1994)	115,000,000
3¼% Convertible Subordinated Debentures (March 1998)	567,750,000
6⅞% Senior Notes (June 1998)	250,000,000
7% Senior Notes (June 1998)	250,000,000
10¾% Senior Subordinated Notes (September 2000)	350,000,000
8½ Senior Notes (February 2001)	375,000,000
7⅜% Senior Notes (September 2001)	250,000,000
8⅜% Senior Notes (September 2001)	400,000,000
7⅝% Senior Notes (May 2002)	<u>1,000,000,000</u>
Total	<u>\$3,859,750,000</u>

384. In addition to financing from the investing public, Lorello and McGahan caused UBS to provide substantial bank financing for HealthSouth, including a \$587 million Senior Credit Facility in October 2000, \$400 million of short term financing in October 2000, participation in HealthSouth’s \$1.25 billion 5-year revolving credit facility, and so-called “synthetic lease facilities.”

385. In analyzing potential borrowers who seek commercial loans or credit facilities, banks such as UBS are required to perform extensive credit analysis of the borrower after obtaining

detailed financial information from it. Not only is this required by the internal procedures of the bank, but because a bank's commercial lending activities are subject to governmental regulation and oversight, it is required to perform such analysis, and to have in its files documentation that this type of detailed credit analysis occurred. Included in this credit analysis is a detailed review of the borrower's actual and contingent liabilities, its liquidity position, any equity issuance obligations it may have which could adversely affect its shareholders' equity, any debt on which the borrower may be potentially liable, even if not on the borrower's books directly, the quality of the borrower's earnings and the borrower's actual *liquidity*, including sources of funding to support repayment of any loans. In addition, when UBS made large loans to or committed itself to credit facilities for a corporation, it was required to closely monitor the company by frequently reviewing its financial condition and ongoing operations for any material changes and insist that top financial officers of the borrower keep it informed of the current status of the borrower's business and financial condition. As a result, UBS obtained and retained extremely detailed information concerning the actual financial condition of HealthSouth throughout the Class Period.

386. With respect to the financing identified above, UBS documents reveal that, at the same time that UBS and the other Underwriter Defendants were selling the Unregistered Notes to QIBs, UBS had determined, but did not disclose to those QIBs, that HealthSouth was a poor credit and business risk, that UBS did not want to expose itself to that risk, and, therefore, that much of the commercial financing that UBS provided to the Company was approved only in exchange for continued investment banking business from HealthSouth, which was always used to shift HealthSouth debt from Citi/Salomon, UBS and the other Underwriter Defendants to the investing public. 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.”

387. A July 11, 2000 Credit Proposal Memorandum, described UBS’s continued consideration for the approval of a \$687 million credit facility for HealthSouth. In that Credit Proposal, HealthSouth again was given a Credit Risk Rating of “C-6,” which was one of the lowest ranges ascribed by UBS (C-6 to C-8 was the range). In fact, in late 2002, after clients of the fraud were first reported, UBS’s Credit Risk Rating of HealthSouth was only downgraded to C-8, which suggests that a rating of C-6 was already rather low on UBS’s scale. That Credit Proposal explains 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.”

388. The minutes of a May 8, 2002 Leveraged Finance Commitments Committee Meeting, 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.” A C-6 rating was quite low in UBS’s credit rating system. 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 May 2002 Integrated Public Offering of \$1,000,000,000 senior notes. The minutes document 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.”

389. Not only did UBS issue glowing “strong buy” analyst reports, but also worked with the other Underwriter Defendants to sell \$2,325,000,000 of Unregistered Notes after UBS concluded that HealthSouth was such a poor credit and business risk that UBS, before it would invest its own money in the Company, would have to quietly reduce its exposure and would have to obtain substantial fees to sell to the investing public Unregistered Notes that, as described above, would be used in substantial part to pay back UBS and the other Underwriter Defendants. UBS’s internal conclusions were not disclosed in UBS’ analyst reports nor in the several Offering Memoranda that UBS and the other Underwriter Defendants used to sell the Unregistered Notes. Indeed, a July 3, 2002 UBS e-mail discloses that UBS actually took steps to conceal its conclusions from the market. 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.”

390. Thus, throughout the Class Period, UBS was pocketing millions of dollars a year in interest payments and investment banking fees by engaging and participating in the HealthSouth scheme to defraud and stood to continue to collect these huge fees on an annual basis going forward so long as it helped perpetuate the HealthSouth scheme, while its top executives or managing directors pocketed huge returns on their investments – returns created by the very manipulative devices and transactions that were hiding HealthSouth’s true financial condition and artificially inflating its profit.

391. Lorello and McGahan also spearheaded UBS’s financing of several of HealthSouth’s questionable “off-balance sheet” special purpose ventures. These financings, too, were undertaken only as concessions to the Company in order to continue receiving considerable investment banking fees:

(a) 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.

392. UBS identified as a “transaction related issue” with respect to this financing the fact that HealthSouth would disclose in its financial statements either the transaction, which UBS referred to as “cosmetic”; the Company’s 100% guarantee of the loan; or HealthSouth’s agreement to restrict its access to its own UBS loan facility. HealthSouth’s non-disclosure did not impede UBS’s approval of the financing.



393. In December 2001, UBS agreed to act as Lead Arranger on a 12-month \$82.2 million senior secured term loan to First Cambridge HCI Acquisition, LLC (“HCI”), a special purpose entity 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 to be 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.

394. 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.

395. Citi/Salomon made \$1.6 million for underwriting the 1997 public offerings of Capstone Capital Corp. REIT, a company established by Scrushy and Martin – who also served on Capstone’s board of directors along with Tadd McVay. The Capstone account was lucrative for Citi/Salomon, which continued to do merger and acquisition work for the company.

396. Over their more than sixteen-year relationship with the Company, Lorello and McGahan during their tenure at Citi/Salomon and UBS advised HealthSouth on a variety of business combination transactions. A UBS internal presentation identified nineteen “selected” business combinations between January 1994 and July 1999 on which Citi/Salomon/UBS played a lead role in advising HealthSouth that alone were valued by UBS at \$7.7 billion:

Jul 1994	Acquisition of NME Rehab. Div.	\$ 365,000,000
Jun 1994	Acquisition of Diagnosis Health	40,000,000
Dec 1994	Acquisition of ReLife Inc.	220,000,000
May 1995	Acquisition of Novocare Rehab. Hosp. Div.	245,000,000
Jun 1995	Acquisition of Surgical Health Corp.	240,000,000
Dec 1995	Acquisition of Sutter Surgery Centers	60,000,000

Dec 1995	Acquisition of Caremark Ortho. Services	125,000,000
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 ReadCare	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
Dec 1997	Sale of Horizon LT Care/Inst Pharmacy	1,250,000,000
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	<u>50,000,000</u>
Total		<u>\$7,700,000,000</u>

In addition to those selected business combinations, Lorello, McGahan and Citi/Salomon/UBS advised HealthSouth in 1998 and 1999 concerning the Company's aborted spin-off of its inpatient operating segment. Lorello, McGahan and UBS again advised HealthSouth in 2002 in connection with "Project Crimson," which was another aborted attempt to spin-off the Company's surgery center division, and made presentations at three HealthSouth Board meetings (August 8, August 26 and September 17, 2002). This spin-off attempt was designed and intended to continue to cover up HealthSouth's massive financial fraud.

397. Lorello, McGahan, Citi/Salomon and UBS were substantially involved in these deals, advising the Company and its senior executives in all aspects of the transactions. In an August 12, 2002 e-mail from Roderick O'Neill, a member of UBS's Corporate Finance Group, to, among others, Individual Defendants (all former HealthSouth senior employees) Owens, Weston Smith, Tadd McVay, and Bill Horton, O'Neill demonstrates McGahan's control over all aspects of HealthSouth's aborted 2002 spin-off of the Company's surgery center division. That e-mail reveals the extent of UBS's involvement in all facets of the planned transaction, and that McGahan devised the work plan for the transaction, which addressed every aspect of the spin-off, and directed the work to be done by UBS and HealthSouth in order to complete the deal :

In preparation for our Thursday call at 2:00 eastern, McGahan wanted to send out a summary of the work plan and responsibilities:

- 1) Additional financial / operational info on Diagnostic imaging: Weston Smith and Jason Brown
- 2) Detailed financials for Surgery Centers: Weston Smith
- 3) Model of HRC with sale and spin for banks and agencies: Hugh O'Hare
- 4) Bond Covenants / repurchase strategy / tender cost analysis / rating agency / surgery financing: Mike Leder [UBS] and Tadd McVay
- 5) Tax opinions: Bill Horton and accountants
- 6) Press release / draft of Form 10: Bill Horton
- 7) Anticipated questions / written script: Rod O'Neill (first draft)
- 8) Shared services: Bill Owens
- 9) Diagnostic Offering Memorandum / buyers list / confidential agreements: Rod O'Neill
- 10) Surgery audited financial info: Weston Smith
- 11) Working Group List: Scott Wollard

398. In a further demonstration of UBS's substantial involvement, Bill Horton sent an August 23, 2002 e-mail to Rod O'Neill (also sent to, among others, McVay, Smith and Owens) that transmitted for review and comment a draft press release that announced the Company's planned spin-off:

Attached is a revised press release, reflecting comments I received from RMS [Scrushy] this morning. It is subject to his further review. Please review and advise of comments or questions.

O'Neill forwarded that e-mail (with the attached draft press release) to McGahan.

399. The UBS internal presentation also reports UBS's equity research relationship with HealthSouth. That presentation, however, does not even begin to describe the incestuous relationship that UBS—in investment banking, commercial lending and equity research—maintained

with HealthSouth. In fact, a former HealthSouth senior executive has advised Lead Plaintiffs that Scrushy handpicked defendant Capek to become UBS's analyst for HealthSouth.

400. Further describing the breadth of UBS's relationship with HealthSouth, the UBS internal presentation also stated that UBS "provides a platform for HealthSouth to raise its market profile and awareness." UBS also stated that HealthSouth presented at each of the annual Global Healthcare Conferences UBS held in 2000, 2001 and 2002 (*i.e.*, in each year after Lorello and McGahan joined UBS), and highlighted that, at the February 2001 conference, "HealthSouth was showcased on a special day of presentations where only a select 14 top healthcare services companies were allowed to present," and that, at the February 2002 conference, "HealthSouth was the Keynote lunch presentation." UBS also listed several UBS-sponsored "non-deal roadshows" that UBS conducted for HealthSouth over the course of seven days in 2000 and 2001 with over thirty UBS accounts.

401. Other UBS documents plaintiffs reviewed included a Saturday, October 13, 2001 UBS e-mail from McGahan to Owens, who was then HealthSouth's President and Chief Operating Officer, in which McGahan advised Owens concerning a UBS presentation at an upcoming HealthSouth Board of Directors meeting. McGahan made several suggestions to Owens – again demonstrating the depth and breadth of his and UBS's knowledge of HealthSouth's core operations and finances, and how much the Company relied upon UBS – including the following :

- A comparison of "capital structure, access to capital, cost of capital, reliance upon banks, where our debt was trading on a yield to maturity, etc." between "the end of last summer vs. where we are today."
- "look at the next challenges: the bank line expiring, the converts [the March 1998 Registered Notes] coming due. The options we have to get the bank debt down over the next 6 to 12 months (cash flow from operations, asset sales, converts, more senior notes, etc.)"
- "we should look at what analysts were saying then [last summer] versus what they are saying today. Are they factoring in the upside of PPS?"

- “look at the new institutions that have come into the stock over the last year.”
- “look at the future. Medicare cuts are going to happen, and commercial payors will tighten again – its [sic] a question of when. What does that mean to us.”
- “lastly, other opportunities (M&A). When do we play offense again?”

McGahan’s e-mail demonstrates his intimate familiarity with HealthSouth’s finances, as well as with the Company’s core operations and strategic planning, going as far as advising on the potential impact on HealthSouth from (a) Medicare’s prospective payment system, (b) anticipated Medicare and private insurer payment cuts, (c) new institutional investors, and (d) the advisability of a new merger and acquisition campaign.

402. This was not the only time Lorello or McGahan advised HealthSouth’s Board, nor was it the only example of Citi/Salomon and UBS providing detailed advice about core HealthSouth affairs. Indeed, Citi/Salomon’s and UBS’s extensive knowledge of, and involvement with, HealthSouth’s ongoing operations, which went well beyond the customary investment banking relationship, is eminently demonstrated by Citi/Salomon’s and UBS’s unusually frequent and extraordinarily in-depth participation at HealthSouth Board meetings. Minutes of certain of HealthSouth Board meetings reveal, for example, that Citi/Salomon’s and UBS’s relationship with HealthSouth went beyond the typical transaction-by-transaction consulting and occasional transaction-specific Board appearances. Whether at Smith; Barney, Harris Upham & Co., Inc.; Smith Barney Shearson Inc.; Smith Barney Inc.; Warburg Dillon Reed, L.L.C.; or UBS Warburg L.L.C., Lorello and McGahan, among others, participated in, and provided advice concerning, long-term core HealthSouth business matters. Those minutes show that Lorello and McGahan – who attended and presented at a total of eighteen Board meetings, eight of which were between late 1999 and late 2000 – were regular fixtures at HealthSouth Board meetings. Although many of the minutes that plaintiffs have obtained without the benefit of discovery were heavily redacted to delete the

content of the Citi/Salomon and UBS presentations, examples of the extraordinary consulting on “core strategies” include:

- **October 15-16, 1997.** Lorello, McGahan and Geoffrey Harris (then of Smith Barney Inc.) presented “an overview of the current market prospects for the near term,” and “a detailed analysis of possible options with respect to [HealthSouth’s] continued growth and expansion.”
- **March 6, 1998.** Lorello and McGahan (of Smith Barney Inc.) presented “for the Board’s consideration a proposal for [HealthSouth] to raise additional capital through a debt offering” with a Rule 144A exchange structure.
- **August 19-20, 1998.** Lorello and McGahan (of Smith Barney Inc.) presented “a variety of options for strategic growth of the [Company] that included acquisition of companies in related businesses, acquisition of companies in non-related businesses and other ways to fuel the growth of the [Company].”
- **March 9, 2001** (attended by Lorello and McGahan, now of UBS Warburg LLC). McGahan presented “an analysis of the equity markets”; “an overview HealthSouth,” including “the positive momentum in [HealthSouth’s] stock as a result of a successful bond offering and [UBS-organized] roadshow”; and a review of the Company’s “2003 financing needs,” including “options to be considered.”
- **November 14-15, 2001** (attended by Lorello and McGahan). McGahan presented a “comprehensive analysis” of HealthSouth over the past twelve months, “an analysis of what Wall Street [wa]s saying about HealthSouth, the potential impact of PPS and a detailed overview of strategic alternatives for [the Company’s] consideration in setting long-term objectives.”
- **August 8, 2002** (attended by McGahan and three colleagues from UBS Warburg LLC). Scrushy “invited McGahan and his associates to join the meeting and to present to the Board a detailed analysis of a strategic plan to spin or split the surgery division (Project Crimson).”
- **August 26, 2002** (attended by McGahan and five colleagues from UBS Warburg LLC). Scrushy asked “McGahan and his associates to lead the Board through a strategic alternative discussion on Project Crimson.” UBS presented “a review of a segment valuation and a discussion of ways to improve business focus by considering several alternatives, including the sale of the diagnostic facilities combined with the split off of the surgery centers, the sale of the surgery centers, the spin off or split off of the surgery centers (with or without IPO) and the sale of the diagnostic facilities.” UBS then presented “a debt analysis and discussed how the current debt profile impacted the alternatives being considered.” UBS’s presentation concluded with “a summary of the timeline of events to take place” and “a discussion of the key separation decisions that needed to be made by” HealthSouth.
- **September 17, 2002.** Lorello and McGahan made another presentation on “Project Crimson.”

403. A former HealthSouth senior executive has informed Lead Plaintiffs that after Lorello, McGahan and Geoffrey Harris (Citi/Salomon's HealthSouth analyst) left Citi/Salomon in 1999 to join UBS, Harris received a promotion that prevented him from continuing to provide analyst coverage for HealthSouth. Demonstrating that the intimate relationship that investment bankers Lorello and McGahan maintained with HealthSouth was more important to them and to UBS than their legal and ethical obligations, Lorello and McGahan, in clear violation of the so-called "Chinese Wall" between investment banking, on the one hand, and analyst research, on the other, invited Scrushy to select UBS's new HealthSouth analyst. In response, 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 HealthSouth stock, push it higher through a series of extraordinarily bullish and false and misleading analyst reports, while acting as HealthSouth's main investment banker and also becoming intimately involved in HealthSouth's business operations and planning, advising Scrushy and the HealthSouth Board constantly on business strategy matters well beyond the scope of traditional investment banking services.

404. Once on board at UBS, Capek:

- Immediately initiated UBS's coverage of HealthSouth with a "Strong Buy" recommendation.
- Maintained that recommendation notwithstanding his own 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."

- 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.”
- Though he disclosed these views and sent supporting documentation to Ms. Zeeb, Capek never disclosed his views, or the support for them, in any of his published research reports.
- 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: 1) that he knew that HealthSouth was improperly capitalizing expenses; 2) that UBS knew all about the financial fraud from conversations McGahan had with senior HealthSouth executives; and 3) that 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.*

405. Lorello’s and McGahan’s desperation to maintain their profitable relationship with HealthSouth, Scrushy, Owens and others at the Company was so intense that, even when UBS was backing away from the Company in March 2003 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 continued financing to HealthSouth. 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 late February and early March 2003 to obtain from UBS a \$22 million 10-month senior unsecured loan 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, reveal strong opposition to UBS approving Corporate Finance’s request:

- 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.” 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+.” That committee, which was very concerned about information HealthSouth had provided, determined to instruct Corporate Finance 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.”

406. The following series of e-mails concerning these two transactions occurred on March 6 and 7, 2003:

- 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 [T]uesday. 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 [T]add and [R]ichard [D]avis 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 [B]en 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

These e-mails 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.

**Defendants Lorello, McGahan and Capek Had Direct Knowledge of the Fraud at the Very Same Time Citi/Salomon or UBS Provided Investment Banking and Analyst Services for HealthSouth**

407. Defendants Lorello, McGahan and later Capek had direct knowledge of the fraudulent nature of HealthSouth's accounting at the very same time Citi/Salomon or UBS Warburg was helping HealthSouth arrange its stream of acquisitions, selling billions of dollars of its securities to the public, and issuing glowing analyst research reports "strongly" recommending that investors buy HealthSouth securities. App. 7.

408. Capek also had actual knowledge of HealthSouth's financial fraud. In or about the summer of 2001, Capek acknowledged to an acquaintance formerly employed by HealthSouth that he knew that HealthSouth had been improperly capitalizing expenses as part of its scheme to inflate its earnings. Capek told the acquaintance, in words or substance: "The Company is going to have to stop capitalizing expenses."

409. McGahan also had personal knowledge of the financial fraud. In or about June or July 1999, HealthSouth was on track to miss its earnings target for the year by approximately \$280-\$300 million. In the past, HealthSouth had made false acquisition entries to provide cover for their overstatements of revenue and earnings. Accordingly, the Company was desperately looking to make another acquisition to cover up this gaping hole in its financial statements. At that time, however, there were very few, if any, appropriate acquisition candidates in HealthSouth's business sector. Thus, HealthSouth began to look at high-end nursing homes, and ultimately decided on HCR-Manor Care as a potential acquisition candidate.

410. UBS was retained to act as HealthSouth's investment banker for this prospective acquisition. Certain of the Senior Officer Defendants were concerned that a due diligence

investigation conducted by the prospective merger partner would uncover HealthSouth's financial manipulations. In June or July 1999, a senior HealthSouth executive involved in the Financial Fraud told McGahan that HealthSouth had been systematically falsifying its financial statements, explained the manner in which the fraud was being accomplished, stated that the Company was on track to miss earnings estimates by \$280 to 300 million, and asked McGahan to help him persuade Scrushy not to proceed with the merger for fear the fraud might be revealed. McGahan promptly agreed to assist that executive in successfully talking Scrushy out of proceeding with the merger. According to that executive, none of the information he conveyed to McGahan appeared to surprise McGahan. But even if McGahan was previously unaware of the scheme, as a result of this conversation with the senior executive, McGahan and UBS had actual knowledge of the particulars of the fraud since 1999.

411. In addition, from 1999 through at least the Fall of 2002, McGahan had regular conversations with at least one former HealthSouth executive who had been involved in the Financial Fraud 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 follow from such prosecution, including the possibility that McGahan and senior HealthSouth executives could go to prison. According to that former executive, 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 helped sell billions of HealthSouth Notes despite McGahan's personal knowledge of the fraud, the former executive said in substance, "If I'm going, you are going too." McGahan did not offer any protest to the former executive's observation.

412. Lorello also was fully aware of the fraud at HealthSouth. In addition to being kept fully apprised of all HealthSouth related developments by McGahan, Lorello affirmatively took steps to insure 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 Harris, who, together with his subordinates, was responsible for implementing the false accounting entries. At his sentencing proceeding, 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.”

413. 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.” This voicemail, which Lorello left for Martin at the time that the Company’s accounting staff were closing HealthSouth’s books for a quarter, shows that Lorello knew that the Company’s results did not meet Wall Street’s expectations, that the “family” needed to “make things happen” so that HealthSouth could report the expected results, and that Lorello needed to pressure those members of the “family” to do so. Accordingly, even if one presumes that McGahan somehow failed to share with Lorello what he had been told in 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.

414. Lorello's voicemail message substantially undermines the sworn testimony that Lorello provided at the November 5, 2003 hearing conducted by the E&C Committee in connection with its investigation into the HealthSouth accounting fraud. At that hearing, Lorello repeatedly denied any knowledge of any of HealthSouth's financial improprieties, and stated that, just as the Company had misled the investing public, HealthSouth had misled him and all of the other Citi/Salomon/UBS investment bankers.

415. Capek also denied knowledge of any impropriety at HealthSouth when he testified before the E&C Committee on November 5, 2003. The facts set forth above unequivocally demonstrate that Lorello, McGahan, Capek, Citi/Salomon, UBS and the other Underwriter Defendants knew about HealthSouth's vast accounting fraud and, as a result, knew that the Offering Memoranda they distributed in order to sell the Unregistered Notes were materially false and misleading. For the same reasons, these defendants also knew that the Registration Statements and Prospectuses that HealthSouth filed with the SEC and distributed to holders of the Unregistered Notes in order to consummate the exchanges for Registered Notes were materially false and misleading, yet these defendants did not cause HealthSouth to correct the Registration Statements or Prospectuses or inform the SEC about the material misstatements in those filed documents. Thus, these defendants participated in a scheme to evade the registration requirements of the Securities Act and the liability provisions thereunder. As a result, the registration exemption provided in Rule 144A is not available to the Underwriter Defendants and, accordingly, the Underwriter Defendants are "underwriters" and "sellers," as defined in and under the Securities Act, with respect to each materially false and misleading Offering Memorandum, Registration Statement and Prospectus, as alleged herein.

416. These facts also unequivocally demonstrate that UBS, Lorello, McGahan and Capek had direct knowledge of the fraudulent nature of HealthSouth's accounting at the very same time

UBS was issuing glowing analyst research reports “strongly” recommending that investors buy HealthSouth securities. 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 the 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. App. 6.

#### **ERNST & YOUNG’S PARTICIPATION IN THE MISSTATEMENTS**

417. HealthSouth perpetrated its massive fraud with the participation of defendant E&Y, which on a quarterly basis, reviewed HealthSouth’s financial results before they were publicly released, and which annually reported and falsely represented in unqualified auditor’s reports, that those financial statements were fairly presented when they were not. Also, E&Y represented that it had conducted its audits in accordance with Generally Accepted Auditing Standards (“GAAS”) when it had not, and represented it was independent when it was not.

418. E&Y issued the following report with respect to HealthSouth’s 1999 financial statements:

#### **REPORT OF INDEPENDENT AUDITORS**

The Board of Directors

HEALTHSOUTH Corporation

We have audited the accompanying consolidated balance sheets of HEALTHSOUTH Corporation and Subsidiaries as of December 31, 1998 and 1999, and the related consolidated statements of income, stockholders’ equity and cash flows for each of the three years in the period ended December 31, 1999. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of HEALTHSOUTH Corporation and Subsidiaries at December 31, 1998 and 1999, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

ERNST & YOUNG LLP

Birmingham, Alabama

March 19, 2000

419. E&Y issued nearly identical reports on HealthSouth's 1996, 1997, 1998, 2000 and 2001 consolidated annual financial statements as of, and for the years ended December 31, 1996-2001. In fact, these representations were materially false and misleading as HealthSouth's financial statements were not presented in conformity with GAAP, nor had E&Y conducted its audits in accordance with GAAS.

420. E&Y also consented to the incorporation of its false reports on HealthSouth's financial statements in HealthSouth's Reports on Form 10-K for those years. E&Y's issuance of, and multiple consents to reissue, materially false reports on HealthSouth's 1997-2001 financial statements were themselves violations of GAAS.

### **E&Y's Long Term Relationship with HealthSouth**

421. E&Y, a firm of certified public accountants, was engaged by HealthSouth to provide independent auditing and accounting services throughout the Class Period. E&Y's Birmingham



office was engaged to examine and report on HealthSouth's annual financial statements for 1997-2001, to perform review services on HealthSouth's interim results, and to provide significant consulting, tax and due diligence services throughout 1997 through 2001. Among the consulting services E&Y rendered to HealthSouth were audits of its nationwide operations for compliance with Medicare and other governmental regulations.

422. Defendant E&Y is the successor international accounting firm to the firms of Ernst & Whinney and Arthur Young, which merged in 1989 to form E&Y; for some six years prior to that merger, Ernst & Whinney serviced HealthSouth as its purported independent auditors, and, after the merger, E&Y continued to do so.

423. HealthSouth was the single most important client for E&Y's Birmingham office and the fees from HealthSouth were particularly important to the partners on the engagement, including Dick Dandurand, James Lamphron, Neas, and William Curtis Miller.

424. Consulting and business advisory services (now auditing services) are a major activity of E&Y. E&Y holds itself out as the leading integrated professional services firm integrating financial auditing and consulting services; it represents that its Health Care Consulting Practice provides consulting services to hospitals, ambulatory care facilities, nursing homes, home health agencies, managed care organizations, physician groups, and other health care organizations, including HealthSouth and other businesses similarly interested (the "healthcare industry"). E&Y has been the auditor for many other healthcare companies accused of overbilling Medicare, including HCA and CPC, and knew the types of manipulations healthcare companies committed.

425. Consulting services in the healthcare industry is a major contributor to the revenues of E&Y. In 1994 and 1995, E&Y achieved total revenues from consulting services of \$772,000,000 and \$1,051,000,000, respectively, of which consulting services in the healthcare industry provided more than half the revenues. In 1990, its consulting revenues were \$740,000,000.

426. E&Y annually received hundreds of thousands of dollars for doing financial auditing work for HealthSouth, and about twice as much for non-auditing services. For services in 2001, E&Y billed HealthSouth \$1,200,000 for financial auditing services and more than twice as much, \$2,500,000 for consulting services. Substantially similar fees for financial auditing were billed by E&Y to HealthSouth and paid by it to E&Y in 1997, 1998, 1999, and 2000.

427. HealthSouth management was well aware of E&Y's audit techniques due to the large number of former E&Y personnel in HealthSouth's management. E&Y partners and members of its professional staff, who became members of HealthSouth's senior management include: James Bennett, who joined HealthSouth in May 1991 and became President and Chief Operating Officer in 1992, was on the audit staff of E&Y (then known as Ernst & Whinney) from October 1980 to August 1989, in its Alabama office; Owens, who specialized in healthcare finance and auditing with E&Y before he joined HealthSouth in March 1986 as Controller and eventually became Executive Vice President and Chief Financial Officer in February 2000, and President and Chief Operating Officer in August 2001; Weston Smith, a CPA with E&Y before joining HealthSouth in February 1987, became Controller of HealthSouth in March 2000, and Executive Vice President and Chief Financial Officer in August 2001; and Livesay, Angela Ayers, Cathy C. Edwards, Kay Morgan, and Virginia Valentine, all employed by HealthSouth in various positions in its accounting and finance departments, were from E&Y professional staff. E&Y thus knew that HealthSouth personnel were aware of E&Y's standard audit tests, including that E&Y never questioned transactions less than \$5,000. Moreover, E&Y auditors were reticent to question HealthSouth management about accounting issues with "professional skepticism" due to their hope to be employed by the Company at some later date, as had happened to many of their former co-workers.

428. E&Y was very involved in meeting with HealthSouth management and regularly attended HealthSouth's Board meetings at which E&Y personnel made presentations. Minutes of

Meetings of Board of Director reflect that the following E&Y representatives attended the following Board meetings:

- February 28, 1997 – Dandurand, Neas and Curt Miller.
- May 1, 1997 – Dandurand, Neas and Miller (participated in discussion focusing on aspects that demonstrated the Corporation’s fiscal controls).
- October 15, 1997 – Dandurand (presented a detailed review of accounting and reporting issues in light of changes from the Financial Accounting Standards Board and the Securities and Exchange Commission).
- March 6, 1998 – Dandurand, Neas and Miller (discussed the SEC requirement for disclosure about “Year 2000” compliance activities in the Corporation’s Annual Report on Form 10-K).
- May 21, 1998 – Dandurand, Neas and Miller (discussed the “Year 2000” issues and the Corporation’s strategy for dealing with any system problems).
- May 20, 1999 – Dandurand, Neas and Miller (detailed for the Board the new accounting developments that would affect future audits, and there was a general discussion about the impact that these might have on the Company’s operations).
- March 4, 2000 – Dandurand, Wayne Dunn and Miller (addressed interim findings and indicated that they were on schedule and found no real issues in any high risk areas).
- May 18, 2000 – Dandurand, Dunn and Miller (discussion of the quality of earnings and quality of accounting: Corporation was sound from an audit perspective).
- March 9, 2001 – Dandurand, James Lamphron, Miller and Dunn (stated E&Y was satisfied with the audit and found no real issue in any high risk areas).
- May 17, 2001 – Lamphron, Tom Hough, Miller and Dunn (reported no significant issues in the required communications and no matters considered as material weaknesses).
- March 15, 2002 – Lamphron, Miller, Dunn and Karol Lloyd (led the Board through a discussion of recent national events with Enron and Arthur Andersen and the effect they have had on audit firms; stated that E&Y focused heavily on those types of items and disclosures this year during its audit and found that none of the Enron type of exposures at HealthSouth; discussed the firm’s quality standards).
- May 16, 2002 – Lamphron, Miller, Dunn and Lloyd (reported that E&Y had reviewed the 10-K and the proxy statement and had reviewed in detail the first quarter results with the Audit Committee; reviewed the required communications, management letter and independence letters and found no significant items to report; reconfirmed the independence of the auditors with a high level of confidence).

See App. 5 listing the attendance at selected HealthSouth Board meetings.

429. Because of the major contribution by HealthSouth to E&Y's revenues for consulting and other non-auditing services, because of E&Y's association professionally with business interests of HealthSouth's management, and because of the number of its alumni in the employ of HealthSouth in key financial positions, there was too close an alignment of the interests of E&Y with HealthSouth and its management. Accordingly, E&Y was incapable of exercising the professional skepticism required of independent auditors.

430. On November 12, 2003, in the Harris Proceedings, Harris testified that E&Y turned a blind eye to material issues during the course of its audits of HealthSouth's annual financial statements. Specifically, Harris detailed how E&Y, after discussions with HealthSouth's senior management, which included several from E&Y auditors, systematically issued unqualified audit opinions on HealthSouth's financial statements when, in fact, E&Y had open audit questions regarding those financial statements and HealthSouth's accounting practices. As explained by Harris, these questions were routinely left unanswered at the time E&Y issued its unqualified auditor's reports, opinions and would remain unanswered even after the audit:

THE COURT: I need to go back to something you said. When you talked about the alternatives, you talked about E&Y. Did you have any indirect or direct evidence that they knew what was going on?

THE WITNESS: I didn't have any direct evidence. I just knew that when there were challenging situations during the audit that might expose a problem, then at that point it would be handled at a, you know, senior level, usually Bill Owens would usually meet with the lead partner at E&Y.

THE COURT: Who was?

THE WITNESS: The two that I'm familiar with is Dick Dandurand and Jim Blanthum.

THE COURT: And?

THE WITNESS: They would meet about an issue, and then after their meeting Bill would say, don't worry about that issue, that's been taken care of, and we would

mark that off our audit list. Up until really probably about the last year of audit, E&Y would always provide a list of questions.

THE COURT: In advance?

THE WITNESS: During the audit of things that they wanted. If there were items that were difficult for us to answer or that we really didn't have an answer other than exposing ourselves, you know, we would go to our supervisors, up the chain, and they would say just ignore it and drop it.

*Up until probably 2002 or 2001, you know, you would always get to the end of the audit, and then senior management would put pressure on E&Y that we would have to make our earnings release date, and you would have to wrap-up the audit. And they would say, well, we have to get these questions answered right after the audit.*

*So we would finish the audit, and then they would come back and ask one more time, and we would chose [sic] not to answer the questions, and just tell them we don't have an answer yet, we're working on it. And then after about a week it would just be forgotten about.*

THE COURT: The senior management you are talking about here is who?

THE WITNESS: Bill Owens. Bill Owens was usually the one that made all the decisions as far as what to tell the auditors.

See H.R. at 93:19-95:8.

431. Harris also testified that the accounting fraud at HealthSouth should have been "obvious" to E&Y, and that the only rational explanation was that E&Y was turning a blind eye to the fraud because E&Y did not want to jeopardize its highly lucrative position with its long-standing client. As a result, Harris and his staff believed that it was futile to go to E&Y with concerns over the fraud being perpetrated by HealthSouth:

THE WITNESS: Of course, Kay [Morgan] and I talked a lot about how this would have to be obvious to E&Y.

MR. JAFFE: I'm sorry. I didn't hear you.

THE COURT: He said he and Ms. Morgan, Kay, talked about how it would be obvious to E&Y.

MR. JAFFE: I see.

THE WITNESS: It should be obvious to them. And we don't know why, you know, other than, you know, they have a lot to lose to come forward. So the auditors really were not an option to go to. You know, we didn't complain to senior management –

THE COURT: Hang on just a minute.

THE WITNESS: I'm sorry.

THE COURT: *Are you telling me that you thought it was futile to go to the auditors because you didn't think that they would do anything because they didn't want to lose them as a – HealthSouth as a client?*

THE WITNESS: *Yes, ma'am.*

THE COURT: *Okay.*

H.R. at 88:22-89:15.

432. As a result of the far-reaching scope of services provided by E&Y, they were intimately familiar with HealthSouth's business, including its business relationships. In fact, E&Y actually knew that HealthSouth was manipulating its financial results. In 1994, as part of its audit of HealthSouth's 1993 financial statements, E&Y partner Neas became aware that HealthSouth had manipulated its earnings by \$27 million. This \$27 million included millions of dollars of non-recurring and unusual income that had been included in revenues, tens of millions of dollars of understatement of the contractual adjustment account, and millions of dollars in expenses that had been incurred, but were not accrued. At a party after the 1993 Annual Report was filed, a senior member of the financial management of HealthSouth was talking to Neas and mentioned to Neas that HealthSouth was unhappy that E&Y had not permitted the Company to record a \$3 million acquisition charge as non-recurring rather than as a normal charge against income. Neas responded in words or substance, "don't talk to me about that; you know that I turned my head on the \$27 million." Thus, Neas and E&Y had actual knowledge both that defendants inflated HealthSouth's financial results and exactly how they did it. This knowledge continued to all of the Company's subsequent financial statements issued during the Class Period. Moreover, the items that comprised the \$27 million of fictitious earnings in 1993 were the same types that were used by the "family" to

perpetrate the financial fraud throughout the Class Period. Accordingly, E&Y was aware of, but turned a blind eye to, the very elements used by HealthSouth to effect one of the largest financial frauds in U.S. history.

433. E&Y also ignored the fact that HealthSouth failed to make nearly \$53 million in adjustments E&Y had proposed pertaining to certain HealthSouth facilities. The SARC wrote:

By law or, in the case of partnership or joint venture arrangements, by contract, the financial statements of certain HealthSouth facilities must be audited annually. These “stand alone” audits, i.e., those conducted separately from annual audits of the Company’s consolidated financial statements, at times resulted in proposed adjustments to a facility’s financial statements. The proposed entries reflected the auditors’ judgment that certain adjustments were necessary or appropriate to the presentation of the facility’s financial statements in conformity with Generally Accepted Accounting Principles.

E&Y, the independent outside auditor of HealthSouth’s consolidated financial statements, also was engaged to perform most of the required “stand alone” audits. In certain of those audits the “stand alone” financial statements reflected the effect of adjustments proposed by E&Y. The Committee, however, found no evidence that such adjustments actually were recorded in the Company’s general ledger or reflected in its consolidated financial statements. The Company’s unrecorded audit adjustments totaled nearly \$53 million as of December 31, 2002.

434. GAAS, as approved and adopted by the American Institute of Certified Public Accountants (“AICPA”), relate to the conduct of individual audit engagements. Statements on Auditing Standards (codified and referred to as “AU”) are recognized by the AICPA as the authoritative interpretation of GAAS.

435. GAAS sets forth the accepted standards of practice for auditing. E&Y violated GAAS General Standard No. 2, which requires that an independence in mental attitude be maintained by the auditor in all matters related to the assignment. Indeed, a crucial component of the regulatory framework of the federal securities laws is the requirement that all public companies have their financial reports audited by independent certified public accountants. As the Supreme Court made clear in *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 (1984), this requirement of “total independence” on the part of auditors stems from two considerations: first, that

auditors occupy a crucial “public watchdog” function, and second, that the audits they perform are for the purpose of fostering “public faith” in the reliability of corporations’ financial statements – faith that “depends upon the public perception of the outside auditor as an independent professional” and without which “the value of the audit function” might well be lost. That vital “public perception” of independence – heavily reliant upon the “appearance” of independence – lies at the very heart of auditor independence. In its relentless pursuit of profits deriving from relationships with its audit client, HealthSouth, E&Y lost sight of, and failed to meet, the high standards for the public perception of independence articulated by the Supreme Court in *Arthur Young*, a case involving one of E&Y’s predecessor firms. E&Y did not maintain such independence in connection with its engagement by HealthSouth. As more particularly alleged herein, E&Y compromised its independence, ignored conflicts of interest, and permitted its quest for fees to override its professional responsibility.

436. The SEC has summarized the role and importance of independent auditors as follows:

Independent auditors have an important public trust. Every day, millions of people invest their savings in our securities markets in reliance on financial statements prepared by public companies and audited by independent auditors. These auditors, using Generally Accepted Auditing Standards (“GAAS”), examine issuers’ financial statements and issue opinions about whether the financial statements, taken as a whole, are fairly presented in conformity with Generally Accepted Accounting Principles (“GAAP”). While an auditor’s opinion does not guarantee the accuracy of financial statements, it furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an impartial and skilled professional and that investors can therefore rely on them. Providing that assurance to the public is the auditor’s over-arching duty.

Investors must be able to put their faith in issuers’ financial statements. If investors do not believe that the auditor is truly independent from the issuer, they will derive little confidence from the auditor’s opinion and will be far less likely to invest in the issuer’s securities. Fostering investor confidence, therefore, requires not only that auditors actually be independent of their audit clients, but also that reasonable investors perceive them to be independent.

Revision of the Commission’s Auditor Independence Requirements, File No. S7-13-00, 2000 SEC LEXIS 1389, at \*3-\*5 (June 30, 2000). Further, the SEC has noted that independence may be



compromised where the accounting firm becomes a primary business advisory service and the revenues from non-audit services become disproportionately greater than revenues from audit services, and where the audit client hires an increasing number of accounting firm partners, or professional staff for high-level management positions. Final Rule: Revision of the Commission's Auditor Independence Requirements, SEC Release No. 33-7919, 2000 SEC LEXIS 2717 (Nov. 21, 2000).

437. The securities laws give the SEC authority to require that financial statements be certified by an independent public accountant. The SEC has exercised this authority by issuing its Regulation S-X, which requires that accountants be independent when they audit public companies. In particular, Regulation S-X's definitions of both "accountant's report" and "audit" require the use of "independent" auditors; see Regulation S-X, Rule 1-02(a)(d), 17 C.F.R. §210.1-02(a)(d). Moreover, both the definition of "audit" in Rule 1-02(d) and Rule 2-02 further require that audits be performed in accordance with GAAS, which, in turn, require auditors to be independent; see Regulation S-X, Rules 1-02(d) and 2-02.

438. In addition, Rule 2-02 further requires auditors to state affirmatively that they performed their audit in accordance with GAAS; see Regulation S-X, Rule 2-02(b). Rule 2-01 provides that the SEC will not recognize an auditor as independent if, when considering all the relevant circumstances, the auditor is not in fact independent. See Regulation S-X, Rule 2-01. The independence requirements of GAAS embrace both "fact" and "appearance," and specifically require auditors to avoid situations that may lead others to doubt their independence:

It is of utmost importance to the [auditing] profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be

intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

*AICPA Codification of Statements on Auditing Standards*, at AU §220.03.

439. To be free from improper professional conduct in the independence arena, each auditing firm must adopt, implement, and maintain a thorough system of quality control policies and procedures to provide it with reasonable assurance that it is conforming to GAAS, including its independence standards, in its audit engagements. AU §161.02-03; AICPA Professional Standards, Vol. 2, QC §20. The AICPA Professional Standards require that firms “establish quality control policies and procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards in its audit engagements.” AU §161.02. Accord at Vol. 2, QC §20.01. In this regard, a firm has a responsibility to ensure its personnel comply with the professional standards applicable to its accounting and auditing practice. *Id.*, §20.03. Among other elements, the quality control policies and procedures applicable to a firm’s accounting and auditing practice should encompass the elements of independence. *Id.*, §20.07. And for the element of independence, policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances. *Id.*, §20.09. “The firm and its personnel must be free from any obligation to or interest in the client, its management, or its owners.” *Id.*, §20.10.

440. E&Y’s responsibility, as HealthSouth’s independent auditor, was to obtain “[s]ufficient competent evidential matter ... to afford a reasonable basis for an opinion regarding the financial statements under audit” as to “the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted

accounting principles.” AU §§110.01, 150.02. GAAS, as set forth in AU §326, Evidential Matter, requires auditors to obtain sufficient, competent, evidential matter through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit:

In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he or she should recognize the possibility that the financial statements may not be fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion.

AU §326.25.

441. In addition to plan its audits to discover fraud, E&Y was required to exercise professional skepticism. Indeed, the auditor “must be without bias with respect to the client since otherwise he would lack [the] impartiality necessary for the dependability of his findings. AU §220.02

.07 Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.

\* \* \*

.09 The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.

AU §230.

442. E&Y specifically had a responsibility to plan its audit to discover fraud and, in doing do, not to ignore material income and balance sheet overstatements. According to AU §110.02:

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud....

“The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed.” AU §316.12. One of the factors in assessing the risk of fraudulent financial reporting is whether there is a known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws. AU §316.17. Among the conditions that should cause the auditor to consider that a client has attempted financial fraud are discrepancies in the accounting records, such as transactions not properly recorded as to amount, accounting period classification or client policy, or unsupported or unauthorized balances or transactions; conflicting or missing evidential matter, such as significant unexplained items on reconciliations; or denied access to records. AU §§316.25, 317.09. To limit the risk of financial statement misstatement as a result of fraud, the auditor should perform procedures, including a detailed review of the client’s quarter-end and year-end adjusting journal entries and an investigation of any entries that appear unusual as to nature or amount and of significant and unusual transactions, particularly those occurring at or near quarter- or year-end. AU §316.29.

443. E&Y also had a responsibility to notify the audit committee of evidence of fraud:

Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity’s organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the expected nature and extent of communications about misappropriations perpetrated by lower-level employees.

AU §316.38.

444. E&Y was also required to evaluate HealthSouth’s financial statements with respect to illegal acts:

... The auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible illegal acts that could have a material

indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

AU §317.07

445. Scrushy, due to (i) his dominance of and his arbitrary manner in dealing with, all aspects of HealthSouth's business and its management; (ii) his frequent overriding of HealthSouth's inadequate internal controls and his opulent personal lifestyle and the financial tensions it created; (iii) his dependence on huge annual HealthSouth bonuses, which he got only upon HealthSouth meeting profit goals; and (iv) his dependence upon HealthSouth's stock sales, the proceeds of which were dependent on the stock price, made Scrushy rank at the very top of E&Y's "fraud risk" profile, which mandated exceptional skepticism and extended audit activity. E&Y ignored this red flag.

446. HealthSouth operated in a tightly regulated industry, healthcare, and was very dependent upon government reimbursement under Medicare for a very substantial portion of its revenues, which reimbursement was subject to strict rules, restrictions and procedures that HealthSouth was legally bound to follow and comply with. E&Y knew from substantial prior experience with other public health care companies that those types of companies are under financial pressure to cheat Medicare to meet profit goals, especially where the business was as dependent on Medicare and Medicare-dependent reimbursement payments as was HealthSouth. Notwithstanding this significant risk, E&Y was aware that HealthSouth did not have in place any effective legal compliance system to conform to the legally mandated Medicare policies or procedures and was in fact circumventing these rules.

447. In fact, E&Y actually was aware of, but ignored, many "red flags" that should have caused the auditors to significantly expand E&Y's audit procedures, at a minimum, or to refuse to issue an unqualified report. Those red flags include:

- E&Y's engagement partner Neas admitted in 1994 that he "turned his head" with respect to fictitious entries that resulted in \$27 million in overstatements of assets and earnings on HealthSouth's 1993 financial statements.

- As the SARC reported, the improper entries shared other characteristics as well. They:
  - typically were in large dollar amounts;
  - routinely carried generic, non-descriptive explanations;
  - often were not accompanied by contemporaneous documentation or other support;
  - were extraordinarily long - often exceeding 200 lines;
  - were entered in the accounting system through external uploads;
  - were booked to inter-company and corporate suspense accounts and otherwise affected accounts not normally associated with one another;
  - many entries self-reversed during successive reporting periods;
  - many improper entries contained designated letter prefixes; and,
  - many of the employees who recorded them were at least generally aware that they were incorrect or unsupported.
- The HealthSouth facilities had so many revenue increases which were unexpected and unexplained that the increases became routine. The SARC noted:
 

Unexpected or unexplained revenue increases and expense reductions, which improved the earnings of individual facilities, became so institutionalized at HealthSouth that they were referred to by corporate accountants as “management entries” and by operations personnel as “gifts,” “pixie dust,” “fairy dust,” or “candy.”
- The SARC also noted the unusual nature of the fraudulent entries resulted in unexpected account balances: Given the method by which non-existent fixed assets were allocated to a particular facility’s books, some AP SUMMARY entries had dollar values exceeding the cost of any asset the facility would have been likely to acquire. At times, therefore, AP SUMMARY assets reflected in the fixed asset system were separated into a number of assets with lesser dollar values. These and other assets sometimes retained the AP SUMMARY designation and sometimes were identified as furniture, computer equipment, or similar items that a facility would be expected to use.
- Many material related-party transactions were entered into – *i.e.*, transactions with business enterprises in which HealthSouth officers and directors held equity interests or management positions – with questionable business purposes.
- The SARC identified transactions and documents that presented opportunities to detect accounting improprieties, including:

- the Company's public disclosures concerning its 1997 acquisition and disposition of assets of Horizon/CMS Health Care Corporation, which refer to an adjustment to goodwill that appears wholly at odds with the economic reality of the transactions;
  - a 1999 complaint to HealthSouth's Vice President of Corporate Compliance, in which the Company's Vice President of Finance expressed concern about the amounts and timing of what she viewed as suspicious quarterly "jumps" in earnings;
  - entries on monthly bank reconciliations, principally those prepared between 1999 and 2001, that failed to correspond with the Company's bank statements; and
  - HealthSouth's systematic practice from 1996 through 2002 of reducing contractual adjustments, even though the applicable contractual adjustments had not actually changed, was accomplished without any support for the reductions.
- HealthSouth's balance sheet manipulations were so pervasive that they resulted in unsupported entries that affected virtually all of the Company's balance sheet asset accounts.
  - Most of the Company's improper accounting entries were made after so-called "first run" consolidations, rather than in conjunction with proper entries made in the ordinary course of the Company's daily operations.
  - HealthSouth's accounting for fraudulent balance sheet entries also departed from customary bookkeeping conventions, those that E&Y should have expected, by recording fraudulent transactions to improve income without recording corresponding entries to balance sheet accounts. Instead, improper income statement entries generally resulted in an increase to a corporate suspense account, which then was reduced by a series of inter-company transfers that increased the assets on various facilities' balance sheets.
  - Changes on the income statement of a particular facility did not necessarily (or even usually) equate to changes on the same facility's balance sheet.
  - To account for assets that did not exist, and thus would not have been recorded in HealthSouth's accounts payable system or processed in its general ledger system in the normal fashion, fictitious assets were added to the fixed asset list during monthly reconciliations without any support.
  - The Company's additional property, plant and equipment general ledger accounts, designated as "New Cap" accounts, contained almost only fraudulent entries.
  - Between 1999 and 2002, a former employee responsible for preparing bank reconciliations regularly misstated either the 1015 Account general ledger balance or transactional activity in the 1015 Account. In the case of misstatements of

transactional activity, specific items totaling the amount of the misstatement were selected and removed from the transactional activity detail that accompanied the reconciliation. There were at least 20 1015 Account entries that resulted in overstatement of the Company's cash balances.

- Certain acquisitions resulted in unsupported additions to goodwill through the creation of “cookie jar” or “rainy day” reserves. The excess reserves later were released to offset amounts improperly transferred to suspense accounts or to avoid recognizing expenses.
- HealthSouth avoided expensing certain bonus payments by reclassifying other balance sheet account activity to bonus accruals. A portion of the improper entries recorded incentive payments as bonus accruals, which later were reduced by increasing other, unrelated balance sheet accounts.
- Within days of HealthSouth's sale of its Caremark stock, the Company reclassified this income to contractual adjustments, which then were reduced as if the Company had received \$19 million in additional operating revenue. At the same time, the Company altered its investment accounts to reflect that it still held 1.7 million shares of Caremark, even though it no longer owned, and never reacquired, those shares.
- Between 1998 and 2002, HealthSouth deferred over \$200 million of expenses by transferring a variety of current expenses to property, plant and equipment accounts, reclassifying those expenses as capital assets, and depreciating them over time.
- The accumulated depreciation general ledger balances were greater than those reflected in the fixed asset system. As a result, there were instances in which excess accumulated depreciation was transferred, typically from an operating facility to one scheduled for closing. This “borrowed” depreciation went to facilities which, when closed (and prior to the depreciation transfer), still would have had non-fully depreciated assets.
- Although HealthSouth closed a number of facilities between 1998 and 2002, assets at those facilities sometimes remained on the Company's books. As of December 31, 2002, the net book value of assets assigned to a “facility” in the HealthSouth accounting system which reported no revenues was nearly \$62 million.
- HealthSouth operated in an industry that was suffering declining margins due to regulatory changes and Medicare reimbursement reductions yet HealthSouth was reporting favorable earnings.
- HealthSouth had significant transactions with related parties, those included 21st Century Health Ventures, in which Scrushy, Martin and Hicks were principals, and through which HealthSouth invested \$10 million. MedCenter Direct.com, formed and financed by HealthSouth, its top executives and investment bankers at UBS and which had over \$100 million per year in sales to HealthSouth; Source Medical Solutions to which HealthSouth advanced \$82 million in start-up costs and guaranteed a \$6 million loan, a company that sells goods and services to over 1,000



HealthSouth operations. (As noted previously (*see* ¶183), the SARC found widespread irregularities in the transactions involving Source Medical.)

- HealthSouth had frequent turnover in senior management, particularly in financial management, with five different CFOs between 1997 and 2002: Beam 10/97; Martin 10/97-2/00; Owens 2/00-8/01; Smith 8/01-8/02; and McVay 8/02-1/03.
- HealthSouth had been sued in qui tam suits in 1996 and 1997 for systematically overcharging Medicare. The intervention of the U.S. Government in one of these cases in 12/01 lent credibility to the qui tam claims. One settled in May 2001 for several million dollars.
- E&Y knew that employees had posted messages on Internet message boards accusing management of falsifying HealthSouth's financial statements.
- HealthSouth had been sued in two previous securities suits for allegedly misleading shareholders. One of these lawsuits settled for \$17 million.
- E&Y knew that the HealthSouth Audit Committee was essentially non-functional, meeting only once or twice a year and then for perfunctory meetings only with members who were all hand-picked by and were beholden to, Scrushy. The HealthSouth Audit Committee also was badly conflicted. It included the Chairman of the Compensation Committee, which handed out lavish pay awards to Scrushy, and had structured an executive compensation system that highly incentivized top executives to manipulate HealthSouth's financial results to hit preset targets and trigger huge cash bonuses, as well as two long-time close personal friends of Scrushy, who had hand-picked them for the Board, and Larry Striplin, the CEO of a glass company for which Scrushy arranged a \$5 million contract to provide glass for a new HealthSouth hospital.
- E&Y knew that HealthSouth's internal controls were weak and easily overridden.
- Internal auditors at HealthSouth were aware that Owens, Beam and Martin put a great deal of pressure on E&Y to complete the audit quickly: "Get in, get the audit done, and get out."
- E&Y received the "fleeced shareholder" memo on November 11, 1998, which described the accounting shenanigans, but E&Y did not seriously explore the matter, or cause HealthSouth to change its accounting.
- E&Y partner Lamphron was forwarded an email in 2002 from former HealthSouth employee Michael Vines, in which Vines stated that HealthSouth was making fraudulent transactions, and actually identified three account numbers to investigate. According to the SARC report, *E&Y's inquiries with respect to the posting apparently did not include an interview of the former employee.*
- In 1998, a HealthSouth employee posted information about HealthSouth on an Internet bulletin board indicating HealthSouth's top executives were "crooks" who were falsifying the Company's financial results by activities reaching down to the

individual hospitals. Rather than investigate or evaluate these activities, E&Y watched as HealthSouth sued this employee for defamation to try to intimidate and silence her. HealthSouth subsequently voluntarily withdrew this suit but the employee never withdrew her allegations of fraud.

- In February 2003, E&Y became aware that “Junior” (actually Vines) had posted information on the Yahoo! Bulletin Board for HealthSouth that HealthSouth was improperly capitalizing operating expenses as assets. Again, E&Y did nothing to investigate or follow up on this warning.
- HealthSouth had previously been accused of improperly categorizing operating expenses as assets. A March 12, 1997 Center for Financial Research and Analysis report stated a concern about “Aggressive Accounting for Startup and Related Costs,” that: HRC capitalizes organization, partnership formation, and startup costs, and subsequently amortizes such costs over a period of three to five years. CFRA feels that such costs should be expensed as incurred, since they appear to constitute ordinary, recurring operating expenses. Had HRC taken that approach, operating income for 1995 would have declined by \$57.0 million; and EPS would have been reduced by roughly \$0.40, to \$0.44 from \$0.84. A 1995 CFRA report also resulted in an April 3, 1995 internal E&Y memo that highlighted E&Y’s recognition of HealthSouth’s problems.
- HealthSouth was controlled by a single individual – Scrushy – who could override accounting controls. Scrushy was extremely focused on meeting earnings targets and promising analysts aggressive earnings growth for future quarters. As Greg Smith, Chief Auditing Officer of HealthSouth, testified before the House Committee on Energy and Commerce on October 16, 2003, Smith reported to Scrushy directly and not to the Audit Committee. Over the course of nine years at HealthSouth (during Scrushy’s tenure), Smith only had two meetings with the HealthSouth Audit Committee separate and apart from management or the Board. Smith testified that, typically, a chief auditing officer will separately meet with the company’s Audit Committee on at least a quarterly basis.

448. Many of these red flags mirrored the risk factors E&Y was required to consider according to AU §316, Fraud in a Financial Statement Audit, including:

- Specific indicators as to include a motivation for management to engage in fraudulent financial reporting.
- An excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend through the use of unusually aggressive accounting practices.
- A practice by management of committing to analysts, creditors, and other third parties to achieve what appears to be unduly aggressive or clearly unrealistic forecasts.
- Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee.

- Management setting unduly aggressive financial targets and expectations for operating personnel.
- Management displaying a significant disregard for regulatory authorities.
- High turnover of senior management, counsel, or board members.
- Claims against the entity or its senior management alleging fraud or violations of securities laws.
- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- Declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Unrealistically aggressive sales or profitability incentive programs.

449. As Congressional investigators noted, based on a May 22, 2002 statement from the E&C Committee:

Reps. Billy Tauzin, R-La. and James Greenwood, R-Pa., who are heading the investigation, said, “We now have evidence that five years ago warnings were given to HealthSouth’s corporate watchdogs ... about the accounting shenanigans at the company. Yet, no one appears to have listened.”

450. Under AU §§230 and 333, E&Y was required to exercise professional skepticism which requires “a questioning mind and critical assessment” of audit evidence. While management’s representations are to be considered by the auditor, they are not a substitute for independent and objective evidence necessary to corroborate the representations reported by management. Moreover, under AU §333, if a representation by management is contradicted by other

audit evidence, then the reliability of all unsubstantiated management representations are called into question.

451. E&Y had actual knowledge of numerous risk factors concerning HealthSouth required to be considered by GAAS (AU §316). These risk factors included: (a) management's compensation was directly tied to the performance of the Company's reported financial results; (b) management had a strong interest in steadily increasing the Company's reported earnings; (c) management's excessive interest in maintaining the price of HealthSouth stock; (d) management was dominated by Scrushy; (e) the internal audit staff had limited authority, and the scope of its activities was not appropriate; and (f) there were non-existent or grossly inadequate internal controls. As the SARC noted: "HealthSouth's internal controls have serious weaknesses, especially in the areas of contractual allowances, receivables, and fixed assets."

452. Specific risk elements known to E&Y included the fact that Scrushy had a strong personality and was involved in the day to day operations of the Company. E&Y also recognized that HealthSouth's management was aggressive, which was an added risk element.

453. Also, E&Y did not place substantial reliance on the work performed by HealthSouth's internal auditors because of HealthSouth's risk profile and HealthSouth's weak internal auditing procedures. E&Y knew that HealthSouth's internal auditors did not have access to HealthSouth's books and records. Similarly, E&Y believed that HealthSouth's internal auditors were inadequately trained.

454. E&Y also primarily audited only the inpatient facilities, neglecting the outpatient, surgery and diagnostic divisions, which contributed a significant portion of HealthSouth's revenue and earnings.

455. Despite these known risks, E&Y deferred to management's decision regarding internal auditing procedures, and did not share its concerns regarding those procedures with HealthSouth's Audit Committee.

456. E&Y's history with HealthSouth included an analysis of a 1995 CFRA report which demonstrated E&Y's knowledge of HealthSouth's manipulations. An April 3, 1995, E&Y Memo from James P. Conley to G. Marcus Neas raised concerns about why HealthSouth's reported income for the first nine months of 1994 more than doubled when same store sales increased by merely 10%, net margins plummeted and interest expense more than doubled. The report attached to the memo said that HealthSouth's "reported long-term debt load is understated by the present value of rent obligations from operating leases ...." It also questioned HealthSouth's reported financial condition from the Capstone sale-leaseback transaction and HealthSouth's aggressive approach in accounting both for acquisitions and for organization, partnership formation and startup costs. It says further that E&Y is "troubled" by the lack of diversity on the Board and Scrushy's "[g]enerous CEO [c]ompensation."

457. The vast number of years, the staggering amount of falsifications and the substantial number of accounts affected are an indication of the extent of the accounting manipulations at HealthSouth. As U.S. Attorney Alice Martin noted, "This investigation is not about a mere accounting fraud, but rather a business scheme to fraudulently boost HealthSouth's reported earnings." Associated Press Newswires, 08/27/03. Yet E&Y continually issued unqualified reports on HealthSouth's financial statements.

**E&Y's False Classification of "Pristine Audits"  
as "Audit-Related"**

458. The Pristine Audits were part of a program HealthSouth launched in 1996. These reviews had nothing to do with E&Y's audits of the company's financial statements. Rather, the

primary purpose of the inspections was to check the cleanliness and physical appearance of HealthSouth's approximately 1,800 surgical and rehabilitation facilities.

459. Under the program, E&Y made unannounced visits to each facility once a year, using dozens of junior-level accountants who were trained for the inspections at HealthSouth's headquarters in Birmingham, Alabama. The accountants carried out reviews armed with a 50-point checklist designed by Scrushy. The checklist included such mundane tasks as seeing if magazines in waiting rooms were orderly, that toilets and ceilings were free of stains, that trash receptacles all had liners, that clean laundry was neatly folded and stored while soiled laundry was stored in a covered container, that floors were free of trash, and if the "overall appearance" of the facility was "sanitary."

460. E&Y advised HealthSouth to classify the payments for the Pristine Audits as "Audit-Related Fees," even though those were non-audit services. In some years, HealthSouth paid E&Y more for the Pristine Audits than it paid for year end financial statement audits. For example, for the fiscal year ended December 31, 2001, E&Y billed HealthSouth \$1,164,750 in "Audit Fees" and \$2,387,676 in "Audit-Related Fees." HealthSouth Proxy dated May 16, 2002 (at p. 17). Similarly, for the fiscal year ended December 31, 2000, E&Y billed HealthSouth \$1,026,649 in "Audit Fees" and \$2,583,854 in "Audit-Related Fees." HealthSouth Proxy dated May 17, 2001 (at p. 18). These "Audit-Related Fees" were in fact fees related to the Pristine Audits as "Audit-Related Fees" to conceal their true nature from the investment community and to reward E&Y for concealing the pervasive accounting fraud at HealthSouth. HealthSouth discontinued the Pristine Audits in March 2003.

461. The Pristine Audit program illustrates how E&Y had become HealthSouth's accomplice when it was supposed to be acting as an independent auditor reviewing HealthSouth's finances with an appropriate degree of professional skepticism.

462. HealthSouth and E&Y knew or were reckless in not knowing as early as 1996 that the Pristine Audit program would create a conflict of interest. For example, in a memorandum dated January 4, 1996 from Teresa Rubio (now Sanders) to Scrushy, with copies to Bennett, Brown, Beam and Owens, Rubio (“Sanders”) warned: “With Ernst & Young handling our annual audit, as well as the site evaluations, issues arising during these visits could affect our year end audit.” Sanders recommended that HealthSouth “[r]etain another firm, possibly Peat Marwick, to handle the site evaluations.”

463. Sanders, a former HealthSouth Internal Auditor, testified before the E&C Committee on October 16, 2003. Sanders’ immediate supervisor was defendant Scrushy, and she reported directly to him for more than nine years. She left HealthSouth’s employ in November of 1999.

464. In 1996, Scrushy approached Sanders about establishing a fifty-point checklist which became known as the “Pristine Audit.” After receiving the January 4, 1996 memorandum, Scrushy instructed Sanders to develop the checklist for his approval. She was further informed by Scrushy that the Pristine Audit was to be handled by E&Y.

465. Sanders developed the fifty-point checklist which Scrushy approved. Sanders testified that the Pristine Audit had nothing to do with auditing the financial books of a field facility but was a “cosmetic, white glove, walk through of a facility. It was in the nature of quality control and had nothing to do with the financial viability of a particular facility.”

466. Due to E&Y’s false statements and failure to identify and modify its reports to identify HealthSouth’s false financial reporting, E&Y violated the following GAAS standards:

(a) The first general standard is that the audit should be performed by persons having adequate technical training and proficiency as auditors.

(b) The second general standard is that the auditors should maintain an independence in mental attitude in all matters relating to the engagement.

(c) The third general standard is that due professional care is to be exercised in the performance of the audit and preparation of the report.

(d) The first standard of field work is that the audit is to be adequately planned and that assistants should be properly supervised.

(e) The second standard of field work is that the auditor should obtain a sufficient understanding of internal controls so as to plan the audit and determine the nature, timing and extent of tests to be performed.

(f) The third standard of field work is that sufficient, competent, evidential matter is to be obtained to afford a reasonable basis for an opinion on the financial statements under audit.

(g) The first standard of reporting is that the report state whether the financial statements are presented in accordance with GAAP.

(h) The second standard of reporting is that the report shall identify circumstances in which GAAP has not been consistently observed.

(i) The third standard of reporting is that informative disclosures are regarded as reasonably adequate unless otherwise stated in the report.

(j) The fourth standard of reporting is that the report shall contain an expression of opinion or the reasons why an opinion cannot be expressed.

### **FALSE AND MISLEADING STATEMENTS**

467. As of the beginning of the Class Period, Defendants' prior false statements were still uncorrected. In fact, it was not until the end of the Class Period that HealthSouth admitted its 1996 financial and operational statements were misstated.

468. For example, on February 24, 1997, HealthSouth issued a press release announcing operating results for the quarter and year ended December 31, 1996.

Excluding non recurring expenses in each year relating to acquisitions, income for the year rose 53%, to \$249 million, compared to \$163 million in 1995. The



corresponding income per share was \$1.49 for 1996, a 38% increase as compared to \$1.08 in 1995. Revenues for the year exceeded \$2.4 billion, a 22% increase over 1995.

\* \* \*

“We are extremely pleased with our 1996 results, which represent HEALTHSOUTH’s tenth consecutive year of meeting or exceeding analysts’ expectations,” said Richard M. Scrushy, Chairman of the Board and Chief Executive Officer.

469. As set forth in detail in Appendix 2, defendants issued false and/or misleading statements during the Class Period concerning HealthSouth’s financial and operational results for each quarter, and each year-end, during the class period. These statements are hereby incorporated into this Complaint. These statements reported the following financial information (before non-recurring expenses).

<b>1997</b>					
	Q1	Q2	Q3	Q4	Year
Revenue		\$723M	\$748M	\$854M	\$3.0B
Income	\$83M	\$81M	\$86M	\$99M	\$342M
Income per share	\$0.22	\$0.23	\$0.24	\$0.25	\$0.94
Increase from prior year	29%	28%	26%	25%	34%
<b>1998</b>					
	Q1	Q2	Q3	Q4	Year
Revenue	\$908M	\$942M	\$1.024B	\$1.04B	\$4.0B
Income	\$109M	\$117M	\$123M	\$117M	\$474M
Income per share	\$0.27	\$0.28	\$0.28	\$0.27	\$1.09
Increase from prior year	23%	23%	24%	8%	18%
<b>1999</b>					
	Q1	Q2	Q3	Q4	Year
Revenue	\$1.03B	\$1.048B	\$993.3M	\$1.001B	\$4.072B
Income	\$110M	\$114B	\$66.9M	\$61.2M	\$352M
Income per share	\$0.26	\$0.27	\$0.16	\$0.16	\$0.85
Increase from prior year	0	—	—		—

<b>2000</b>					
	Q1	Q2	Q3	Q4	Year
Revenue	\$1.021B	\$1.036B	\$1.060B	\$1.077B	\$4.195B
Income	\$65.3M	\$65.2M	\$71.0M	\$76.9M	\$278.5M
Income per share	\$0.17	\$0.17	\$0.18	\$0.19	\$0.71
Increase from prior year	—	—	13%	22%	—
<b>2001</b>					
	Q1	Q2	Q3	Q4	Year
Revenue	\$1.090B	\$1.099B	\$1.076B	\$1.115B	\$4.380B
Income	\$75.3M	\$83.1M	\$79.1M	\$88.6M	\$326.1M
Income per share	\$0.19	\$0.21	\$0.20	\$0.22	\$0.82
Increase from prior year	12%	24%	11%	16%	15.5%
<b>2002</b>					
	Q1	Q2			
Revenue	\$1.130B	\$1.164B			
Income	\$107.7M	\$113.7M			
Income per Share	\$0.27	\$0.28			
Increase from Prior Year	42%	33.3%			

470. Defendants UBS and Citigroup also made false statements about HealthSouth's results as described in Appendices 6 and 7. E&Y issued false audit reports certifying HealthSouth's results as described herein.

#### **False and/or Misleading Statements Issued During the First and Second Quarters of 1997**

471. On April 24, 1997, HealthSouth announced its First Quarter 1997 results, as described in Appendix 2, including income per share of \$0.22. Defendants' false and/or misleading statements concerning HealthSouth's financial results for the first and second quarters of 1997 are contained in Appendix 2.

472. On June 2, 1997, the Dow Jones Online News issued a report on HealthSouth entitled "HealthSouth Gets Morgan Stanley Initial 'Strong Buy' Rating." The report stated Morgan Stanley, Dean Witter, Discover & Co. initiated coverage of HealthSouth Corp. (HRC) with strong buy ratings. Based on information from the Company, Morgan Stanley issued the following statement:

“Morgan Stanley estimates HealthSouth will earn 93 cents a share in 1997 and \$1.14 a share in 1998. The firm set a 12-month share price target of \$29.”

473. Later in June, on June 24, 1997, J.P. Morgan Securities, Inc. issued a report on HealthSouth by Joseph Chiarelli based upon information received from the Company, entitled “HEALTHSOUTH: Initiating Coverage with a Buy and a \$34 Price Target.” The report, rating HealthSouth a “BUY,” contained EPS forecasts of \$0.93 for 1997 and \$1.15 for 1998.

**Reasons Defendants’ Statements Issued During the First and Second Quarters of 1997 Were False and/or Misleading**

474. The statements identified above and in Appendices 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as specifically set forth in this Complaint.

475. As testified to by certain former HealthSouth officers and employees, beginning in 1996 at the latest, defendants deliberately falsified HealthSouth’s numbers in order to meet public estimates and projections, which estimates and projections were originally set by HealthSouth. Scrushy, Owens and others engaged in this illegal scheme by making false entries in HealthSouth’s books and records for the purpose of inflating the Company’s earnings. Defendant Martin, CFO of the Company from 1997 to February, 2000, has now admitted to signing false financial statements, which were then reported to the SEC in false Forms 10-K and 10-Q.

476. Pursuant to this scheme, HealthSouth’s 1996 year end net income was overstated by \$70 million. Thus, the Company’s claims that it was meeting analysts’ expectations in 1997 were also false and misleading, for in fact without perpetrating its financial fraud, HealthSouth could not have posted numbers that met analyst expectations. The SARC reported that HealthSouth’s fourth quarter 1996 and first quarter 1997 income, before taxes and minority interest, were overstated due to improper adjustments by \$70.2 million and \$46.76 million, respectively.

477. Indeed, as early as 1995 HealthSouth engaged in the improper practice of writing off material amounts of costs immediately following its acquisition of other companies. The practice of such writeoffs was noted by CFRA in its memo to E&Y dated April 3, 1995.

478. As a part of this scheme to defraud, HealthSouth engaged E&Y for the first time in 1996 to conduct the “pristine audits” for which E&Y was compensated in amounts equal or greater than the amounts received by E&Y for its routine audit work. The “pristine audit” engagement was intended to, and did, compromise E&Y’s independence, inducing the auditors to overlook numerous irregularities and to rely on management alone to cross-check management’s financial reporting. In the end, the auditors’ deliberate failure to conduct a thorough and independent analysis of management’s numbers resulted in a massive failure of a critical control.

479. HealthSouth continued to tout its ability to grow sequentially from quarter to quarter, despite the fact that the clear effect of the BBA known internally at HealthSouth would be to reduce HealthSouth’s revenues. Moreover, due to the fact that HealthSouth’s financials for 1996 were false, and the Company’s financials were cumulative, the Company’s forward-looking statements, including those relating to future revenue, and the effect of various acquisitions, were necessarily false as well.

480. HealthSouth began its practice of falsifying its Medicare reimbursement claims as early as 1996, as discovered by the nonpublic Cahaba investigation, due to HealthSouth’s failure to obtain certified plans of care, providing services through unqualified personnel, and by billing for individual therapy when in fact group therapy was performed. These fraudulent practices compounded the Company’s inflated revenues created through the falsification of their books.

**False and/or Misleading Statements Issued During  
the Third Quarter of 1997**

481. On July 17, 1997, based on information from the Company, Credit Suisse First Boston issued a report on HealthSouth entitled “HRC: Impressive 2Q EPS Of \$0.23” by Olwell &

Capek. The report, rating HealthSouth a “Strong Buy,” contained EPS forecasts of \$0.94 for 1997 and \$1.15 for 1998.

482. On July 17, 1997, HealthSouth announced its Second Quarter 1997 results, as described in App. 2, including income per share of \$0.23.

483. On August 1, 1997, UBS Equities issued a report on HealthSouth written by O’Donnell. The report contained EPS forecasts of \$0.93 for 1997 and \$1.15 for 1998 and stated:

#### KEY POINTS

The Medicare budget reconciliation act passed by the House and Senate this week includes several changes related to hospitals exempt from the prospective payment system, including HEALTHSOUTH’s rehabilitation hospitals. We do not expect these changes to result in any revision to our current EPS estimates.

\* \* \*

In 1996, Medicare accounted for 37.8% of HEALTHSOUTH’s revenues and its largest concentration of Medicare revenues is in its rehabilitation hospitals. ***From our discussions with management, the budget changes will result in some reductions in reimbursement initially but they are not expected to be large enough to result in earnings estimate revisions.***

484. On August 12, 1997, defendant Scrushy had private one-on-one conversations with securities analysts, including O’Donnell of PaineWebber and Olwell of Credit Suisse First Boston. Several of these conversations occurred at HealthSouth’s headquarters in Birmingham, Alabama. During these conversations, Scrushy told O’Donnell and Olwell that:

- There was no fundamental reason for the recent decline in the price of HealthSouth’s common stock and HealthSouth’s fundamental growth prospects remained intact.
- Same-store sales increases and improvements to recently acquired businesses should easily drive 25% annual earnings growth and provide for upside earnings surprises.
- HealthSouth could continue to grow its revenues by 15% 20% from its current asset base.
- The closure of the Horizon acquisition was imminent and extremely important to HealthSouth, for once it was in place, HealthSouth would have its essential business platform for growth in place, achieve significant same-store cost reductions and meaningfully accelerate internal development between 1998-2000.

- As a result, HealthSouth could easily achieve 1997 and 1998 EPS of \$0.93-\$0.94 and \$1.15, respectively.

485. On August 14, 1997, Cowen & Co. issued a report on HealthSouth entitled “Post Acute Washington Reimbursement Changes” by Sullivan, based on HealthSouth management’s statements. It stated:

**HEALTHSOUTH (HRC): *HRC will emerge relatively unscathed post the adoption of any potential rehab and outpatient changes that we believe could be adopted.***

Inpatient Rehab - Inpatient rehab is roughly 44% of total revenues (pre Horizon acquisition) with half of these coming from the Medicare program. ***Internal budgeting and Street guidance assume zero TEFRA rate increases in 1998 and account for the 15% capital cost reduction.*** Regarding rebasing of TEFRA limits and reducing incentive payment amounts (from the current 5% of target to 3% of target), we believe ***these to be two easy cuts to manage through given the nominal % of revenues exposed as well as the fact that these revenues are being slightly reduced, and not eliminated altogether.***

Outpatient Rehab And Surgery Center - Outpatient and surgery center revenues are roughly 18% and 20% of total HRC revenues (again pre Horizon). ***Medicare represents less than 10% of outpatient revenues and less than 20% of surgery center revenues. As previously mentioned, we believe there to be little likelihood of the adoption of an outpatient PPS in the near future. Coupled with HRC’s low Medicare exposure in these two divisions, we believe there to be little impact on HRC.***

486. On September 3, 1997, HealthSouth announced that it had agreed to acquire ASC Network Corp. for \$180 million in cash and assumed debt. ASC Network operated 29 surgery centers throughout the country. In connection with this announcement, defendant Scrushy spoke to securities analysts, including Jean Swenson at Alex. Brown, Sullivan at Cowen & Co. and Olwell. During those conversations, Scrushy stated:

- The acquisition of Horizon would close in mid-October 1997.
- HealthSouth remained on track and, given its same-store sales growth and operating leverage, HealthSouth would continue to post annual EPS growth of 20%-25% and 1997 and 1998 EPS of \$0.93 and \$1.13-\$1.15, respectively.

487. During the third quarter 1997 Defendant Citi/Salomon also issued positive but false statements about HealthSouth, as described in Appendix 7.

### **Reasons Defendants' Statements Issued During the Third Quarter of 1997 Were False and/or Misleading**

488. The statements identified above and in Appendices 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as specifically set forth in this Complaint.

489. The SARC reported that HealthSouth's second quarter 1997 income, before taxes and minority interest, was overstated due to improper adjustments by \$75.73 million.

490. During this time, Defendants claimed that HealthSouth would continue to post same-store sales growth following the acquisition of Horizon. This statement was false when made. In fact, HealthSouth engaged in the long-established practice of writing off assets following an acquisition to bury its losses. Furthermore, HealthSouth sold the Horizon assets, rather than posting numbers that reflected continued growth in those stores.

491. HealthSouth's claims concerning Medicare reimbursements were false and misleading for the reasons set forth in this Complaint.

492. Defendants' claim that the BBA passed by Congress in July 1997 would not affect HealthSouth's EPS was false, because it was apparent to senior management that the BBA would reduce HealthSouth's earnings. Moreover, defendants' claim that any impact would be offset by the benefits of an outpatient PPS was false, because defendants' billing practices were premised on fraud. As a result, any accurate implementation of PPS would decrease HealthSouth's revenues.

### **False and/or Misleading Statements Issued During the Fourth Quarter of 1997**

493. On October 29, 1997, HealthSouth completed the acquisition of Horizon by merger for approximately \$960 million in stock and the assumption of approximately \$700 million in debt. In connection with the acquisition of Horizon, HealthSouth issued a Registration Statement and Prospectus which: (i) set forth an unaudited balance sheet of HealthSouth as of June 30, 1997, and unaudited statements of operation for HealthSouth for the six months ended June 30, 1997, and

twelve months ended December 31, 1996; (ii) provided forecasts based upon projections provided by HealthSouth and its management to Merrill Lynch Pierce Fenner & Smith Incorporated (“Merrill Lynch”); and (iii) described in positive terms the relationship which HealthSouth had with its managed care providers. On page 18 of the Prospectus, dated September 26, 1997, the risk factors regarding the merger are outlined. HealthSouth stated:

Substantially all of HEALTHSOUTH’s revenues are derived from private and governmental third party payors (in 1996, approximately 37.8% from Medicare and approximately 62.2% from commercial insurers, managed care plans, workers’ compensation payors and other private pay revenue sources). There are increasing pressures from many payor sources to control healthcare costs and to limit increases in reimbursement rates for medical services. There can be no assurances that payments under governmental and third party payor programs will remain at levels comparable to present levels. In attempts to limit the federal budget deficit, there have been, and HEALTHSOUTH expects that there will continue to be, a number of proposals to limit Medicare reimbursements for certain services. HEALTHSOUTH cannot now predict whether any of these pending proposals will be adopted or, if adopted and implemented, what effect such proposals would have on HEALTHSOUTH.

494. On page 42 of the Prospectus, dated September 26, 1997 the investment banker, Merrill Lynch, recommended the proposed merger based upon HealthSouth’s forecasts for FY96-FY2000:

Merrill Lynch reviewed HEALTHSOUTH’s historical financial performance for FY 1994 through FY 1995 and its projected financial performance as set forth in HEALTHSOUTH’s Forecast for FY 1996 through FY 2000, based on HEALTHSOUTH’s public documents (with respect to its historical financial performance) and HEALTHSOUTH’s Forecast. Merrill Lynch reviewed (i) HEALTHSOUTH’s annual percentage revenue and EPS growth from FY 1994 through FY 1995 and HEALTHSOUTH’s forecasted percentage revenue and EPS growth from FY 1996 through FY 2000 and (ii) HEALTHSOUTH’s annual incremental revenue, forecasted revenue, EPS, and forecasted EPS growth for the same periods. Merrill Lynch also reviewed (i) HEALTHSOUTH’s annual incremental EBITDA and EBIT growth from FY 1994 through FY 1995 and HEALTHSOUTH’s forecasted annual incremental EBITDA and EBIT growth from FY 1996 through FY 2000 and (ii) HEALTHSOUTH’s EBITDA, forecasted EBITDA, EBIT and forecasted EBIT as a percentage of HEALTHSOUTH’s revenue or forecasted revenue, as the case may be, for the same periods.



The “risk factors” and forecasts were false and misleading because, as described in detail above, HealthSouth’s financials were materially false. HealthSouth’s prospects were already being materially impacted by the BBA.

495. On October 30, 1997, HealthSouth issued its Third Quarter 1997 financial and operational results, as described in Appendix 2, including earnings of \$0.24 per share.

496. On December 17, 1997, in a deal announced via PR Newswire, HealthSouth signed an agreement to acquire The Company Doctor (“TCD”) for approximately \$19.6 million in HealthSouth stock. Under the terms of the deal, HealthSouth would pay 0.142 of a share of HealthSouth common stock for each TCD share.

497. During the Fourth Quarter 1997, Defendant Citi/Salomon also issued positive but false statements about HealthSouth as described in Appendix 7.

**Reasons Defendants’ Statements Issued During the Fourth Quarter of 1997 Were False and/or Misleading**

498. The statements identified above and in Appendices 2, 6 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as described herein. Specifically, statements regarding HealthSouth’s historical financial information, the impact of the BBA, Medicare reimbursements and future projections based on the false cumulative financials were false and misleading.

499. The SARC reported that HealthSouth’s third quarter 1997 income, before taxes and minority interest, was overstated due to improper adjustments by \$104.95 million.

500. The statements relating to HealthSouth’s financial and operational reporting for this time period were false and misleading for the reason set forth above.

## **False and/or Misleading Statements Issued During the First Quarter of 1998**

501. On February 16, 1998, analyst Sullivan of Cowen & Co. met with defendants Scrushy, Martin, Bennett and Thomson at the HealthSouth headquarters in Birmingham, Alabama. During that meeting, defendants Scrushy, Martin, Bennett and Thomson falsely stated:

- The budget process for 1998 had recently been completed and they each felt very comfortable with HealthSouth's budget, which called for 1998 EPS growth of 25%, which HealthSouth would meet or exceed.
- HealthSouth would meet or exceed 1999 EPS growth expectations of 20% 25%.
- As a result, HealthSouth would meet 1997, 1998 and 1999 EPS estimates of \$0.93-\$0.94, \$1.14 and \$1.40, respectively.

502. On February 17, 1998, Cowen & Co. issued a report on HealthSouth by Sullivan & Miner, based on their meeting with management. The report, rating HealthSouth a "Strong Buy," contained EPS forecasts of \$1.15 for 1998 and \$1.40 for 1999 and stated:

Visit Reinforces Stellar Outlook - Yesterday we visited HRC's headquarters in Birmingham. ***We met with CEO Richard Scrushy, CFO Michael Martin, COO Jim Bennett and the head of HRC's inpatient division, Robert Thompson. We maintain our 1-strong buy rating on HRC. Post our corporate headquarters visit and meetings with top management we believe earnings visibility on HRC's EPS is one of the highest in the health care services universe.***

503. On February 25, 1998, HealthSouth issued its Fourth Quarter 1997 and 1997 results, as described in Appendix 2, including earnings per share of \$0.94.

504. In connection with this announcement, HealthSouth held a conference call, hosted by defendant Scrushy, with institutional investors and securities analysts. During that call and in follow up one on one conversations thereafter, defendant Scrushy falsely stated:

- He was very positive about HealthSouth's financial performance and position.
- HealthSouth's business was strong across all business lines and experiencing substantial growth.
- HealthSouth had a significant competitive pricing advantage in that its Medicare costs were 40% of the industry average (\$10,230 cost per discharge vs. \$19,250).

- As a result, Scrushy remained comfortable that HealthSouth would meet 1998 and 1999 EPS estimates of \$1.15 and \$1.40, respectively.

505. Defendants Citi/Salomon also issued positive but false reports about HealthSouth during the First Quarter 1998, as described in Appendix 7.

**Reasons Defendants' Statements Issued During  
the First Quarter of 1998 Were False and/or Misleading**

506. The statements identified above and in Appendices 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as described herein.

507. Defendants continued to deliberately falsify HealthSouth's numbers in order to meet public estimates and projections set by HealthSouth. Defendant Martin, the CFO of HealthSouth during 1998, has now admitted that the financial and operational reports published by the Company and filed with the SEC were false and misleading and inflated to meet or exceed analysts' expectations.

508. HealthSouth's 1997 year end net income was overstated by 273%, or by \$440 million, and the Company's net income was \$161 million. Thus, the amount of fictitious income for 1997 was \$700 million. The SARC reported that HealthSouth's fourth quarter 1997 income, before taxes and minority interest, was overstated due to improper adjustments by \$168.6 million. The Company's claims that it met analysts' expectations, including same-store growth were similarly false and misleading. Without perpetrating its financial fraud, HealthSouth could not have posted numbers that met analyst expectations.

509. Defendants were aware of HealthSouth's true financial condition. At the March 6, 1998 Board meeting attended by Dandurand, Neas and Miller of E&Y, and Lorello, McGahan and Geoffrey Harris of Smith Barney Inc., Dandurand, Neas and Miller presented an update on HealthSouth's financial audit for 1997, addressed the interim findings and indicated that the audit

would be complete within a few weeks. Martin led the Board through a review of HealthSouth's financial performance for 1997.

510. In addition, HealthSouth falsified its Medicare reimbursement claims as early as 1996. In 1998, these practices were noted internally and reported to the compliance department, which did nothing to pursue or redress the Company's illegal practices. According to her Congressional testimony, Diane Henze realized that HealthSouth was committing fraud with regard to its billing practices and confronted CFO Bill Owens, who did not deny the fraud. Ms. Henze also spoke with Cullison in the compliance department, who confirmed the fraud and referred the matter to her superior, Tanner, the head of compliance and a founder of the company. No action was taken to stop the challenged parties.

511. Defendants' further claim that the Company's costs were 40% of industry average was also based in fraud. By performing group therapy when billing for individual therapy, the Company was able to report lower costs, but these reported costs were of course derived from defendants' fraud, not from actual lower costs for individual therapy provided.

512. Defendants' claim that that BBA passed by Congress in July 1997 would not affect HealthSouth's EPS was false, because it was apparent to senior management that the BBA would reduce HealthSouth's earnings. Moreover, defendants' claim that any impact would be offset by the benefits of an outpatient PPS was false, because defendants' billing practices were premised on fraud. As a result, any accurate implementation of PPS would decrease HealthSouth's revenues.

513. HealthSouth continued to tout its ability to grow sequentially from quarter to quarter, despite that the clear effect of the BBA would be to reduce HealthSouth's revenues. Moreover, due to the fact that HealthSouth's financials for 1996 and 1997 were false, and the Company's financials were cumulative, the Company's forward-looking statements, including those relating to future revenue, and the effect of various acquisitions, were necessarily false when made. The March 20,

1998 Registration Statement was materially misleading because, as HealthSouth has admitted, its financial statements were false. The Registration Statement also misleadingly suggested that there were only pressures “from payer sources ... to limit increases in reimbursement rates for medical services.” However the Registration Statement failed to disclose that HealthSouth’s managed care customers had been seeking significant price reductions on existing contracts and delaying payments to HealthSouth for services it had rendered. Moreover, the “risk factors” were false and misleading because HealthSouth’s business and prospects were already being materially impacted by the BBA.

### **False and/or Misleading Statements Issued During the Second Quarter of 1998**

514. On April 1, 1998, Cowen & Co., based on information provided by HealthSouth’s management, issued an industry report on Health Care service stocks. It stated:

After beating the performance of the S&P 500 for the first nine months of 1997, the post acute care stocks started to show some weakness in Q4:97 and continued to do so in Q1:98. The weakness was tied to industry skittishness over to the **impact** of the impending changes in reimbursement called for in the **Balanced Budget Act** of 1997. We expect the post acute care stocks to muddle along until visibility on prospective payment increases, in spite of any positive news on an individual company basis. **Due to our lukewarm opinion of the nursing home stocks until reimbursement uncertainty clears, we rate only one post acute stock strong buy. HEALTHSOUTH, the industry leader in rehab and outpatient surgery, has a solid fundamental outlook, strong competitive position, and little exposure to reimbursement changes.**

\* \* \*

### **No News on Progress Of Rehab and Long Term Hospital PPS**

Changes in the rehab and long term hospital area included in the Balanced Budget Act of 1997 include a two step process: 1) reduce the maximum TEFRA target amount (facility-specific maximum reimbursement amount per discharge) to the 75th percentile and reduce the “incentive” payments (bonus payment if a facility’s costs are less than the target amount); and 2) change to prospective payment reimbursement for long terms hospitals (phase-in starting 10/1/99) and inpatient rehab (phase-in starting 10/1/00). The impact of #1 is mixed. Vencor’s long term hospital division will experience a revenue and margin hit (enough to flatten margins and earnings in Q4:98, the first quarter to change will be in place of Vencor). **HRC, on the other hand, has estimated that, the annualized hit to revenues will approximate \$10MM, with no impact on earnings estimates.** The impact of #2 on operators is much the same as for the nursing homes: low cost

operators will benefit from the change, being able to keep all of the difference between the prospective payment amount and their cost of delivering care. That being said, HCFA has been more focused on the near term regulations for nursing homes, so while rehab and long-term hospital prospective payment are still slated to happen, there has been relatively little progress on these projects.

515. On the heels of the announcement of the first quarter 1998 earnings, HealthSouth held a conference call, hosted by defendant Scrushy, with institutional investors and securities analysts. During that call and in follow-up one-on-one conversations thereafter, Scrushy falsely stated that HealthSouth's EPS would continue to grow at 20%-25% annually for the next three years and achieve analysts' EPS estimates of \$1.15 in 1998 and \$1.40 in 1999.

516. On April 21, 1998, HealthSouth issued its First Quarter 1998 results, as described in Appendix 2, including earnings of \$0.27.

517. On April 22, 1998, J.P. Morgan issued a report on HealthSouth based on HealthSouth management's statements, which rated HealthSouth a "buy," contained EPS forecasts of \$1.16 for 1998 and \$1.40 for 1999 and stated: "Management was very positive in yesterday's conference call, and results were strong across all business lines."

518. After these positive statements, on May 1, 1998, HealthSouth increased to its all time high of more than \$30.50 per share.

519. On May 6, 1998, HealthSouth announced via PR Newswire that it had signed an agreement to acquire NSC for \$590 million in HealthSouth stock. Under the terms of the deal, HealthSouth would pay no less than 0.8714 shares of HealthSouth stock valued at \$30.50 and no more than 1.1509 shares of HealthSouth stock for each share of NSC stock.

520. In connection with this announcement, HealthSouth held a conference call, hosted by defendant Scrushy, for institutional investors and securities analysts, including Sullivan, Swenson, O'Donnell, A.J. Rice ("Rice") of Bear Stearns and Chiarelli. During that call or in follow-up one-on-one conversations thereafter, defendant Scrushy stated:

- The acquisition of NSC increased the likelihood that HealthSouth would continue to achieve 20%-25% annual EPS growth.
- As a result, he remained confident that HealthSouth would achieve EPS estimates of \$1.15-\$1.16 in 1998 and \$1.40 in 1999.

521. During the week of May 21, 1998, HealthSouth completed the acquisition of TCD by issuing 698,666 shares of HealthSouth stock in exchange for 4,920,183 shares of TCD stock and options to acquire 519,641 shares of HealthSouth stock in exchange for options to acquire 3,659,444 shares of TCD stock. In connection with the acquisition of TCD, HealthSouth issued the TCD Registration Statement (including the TCD Proxy/Prospectus) which (i) included material portions of the financial statements of HealthSouth for 1997 and previous years and specifically incorporated by reference, among other documents, the 1997 Form 10-K and the First Quarter 1998 Form 10-Q; and (ii) stated, among other things:

Substantially all of HEALTHSOUTH's revenues are derived from private and governmental third-party payors (in 1997, approximately 36.9% from Medicare and approximately 63.1% from commercial insurers, managed care plans, workers' compensation payors and other private pay revenue sources). There are increasing pressures from many payor sources to control healthcare costs and to limit increases in reimbursement rates for medical services. There can be no assurances that payments under governmental and third-party payor programs will remain at levels comparable to present levels. In attempts to limit the federal budget deficit, there have been, and HEALTHSOUTH expects that there will continue to be, a number of proposals to limit Medicare reimbursements for certain services. ***HEALTHSOUTH cannot now predict whether any of these pending proposals will be adopted or, if adopted and implemented, what effect such proposals would have on HEALTHSOUTH.***

The TCD Registration Statement was false and misleading because, as described in detail herein, HealthSouth's revenue, earnings and assets were materially overstated, and HealthSouth's business and prospects were already being materially impacted by the BBA.

522. On or about March 20, 1998, HealthSouth commenced an offering of \$567,750,000 3.25% convertible subordinated debentures (the "Offering"), which were convertible into HealthSouth common stock at a price of \$36.25. These securities were priced, in large part, based upon the performance of HealthSouth's common stock and the financial position of HealthSouth.

523. In connection with the Offering, HealthSouth issued a Registration Statement and Prospectus dated June 3, 1998, which incorporated HealthSouth's financial results for 1997 and also stated:

#### REIMBURSEMENT BY THIRD-PARTY PAYORS

Substantially all of HEALTHSOUTH's revenues are derived from private and governmental third-party payers (in 1997, approximately 36.9% from Medicare and approximately 63.1% from commercial insurers, managed care plans, workers' compensation payers and other private pay revenue sources). There are increasing pressures from many payer sources to control healthcare costs and to limit increases in reimbursement rates for medical services. There can be no assurances that payments under governmental and third-party payor programs will remain at levels comparable to present levels. *In attempts to limit the federal budget deficit, there have been, and HEALTHSOUTH expects that there will continue to be, a number of proposals to limit Medicare reimbursements for certain services. HEALTHSOUTH cannot now predict whether any of these pending proposals will be adopted or, if adopted and implemented, what effect such proposals would have on HEALTHSOUTH.*

524. Defendant Citi/Salomon also issued positive but false reports about HealthSouth during the second quarter 1998, as described in Appendix 7.

#### **Reasons Defendants' Statements Issued During the Second Quarter of 1998 Were False and/or Misleading**

525. The statements identified above and in Appendices 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as specifically detailed herein.

526. Again, defendants deliberately falsified HealthSouth's numbers in order to meet public estimates and projections which were originally set by HealthSouth's management. The SARC reported that HealthSouth's first quarter 1998 income, before taxes and minority interest, was overstated due to improper adjustments by \$100.23 million.

527. Defendants' statements that the Company was not in violation of the False Claims Act were patently untrue. As described above, defendants deliberately misreported the services provided by entering the wrong billing codes. Several qui tam actions filed in 1998 were based on



the testimony of former HealthSouth patients, who claimed that HealthSouth improperly charged for individual therapy when performing group therapy. For example, on April 24, 1998, James Devage, a former HealthSouth patient, filed an action in federal district court against HealthSouth, alleging that HealthSouth knowingly and fraudulently overcharged Medicare, including improperly charging for individual therapy when the services performed were actually group therapy. Similarly, in 1998, plaintiff Manning and others alleged that HealthSouth had submitted false Medicare claims beginning in 1995.

528. Defendants' claim that the BBA passed by Congress in July 1997 would only cause an estimated annual hit to HealthSouth of \$10 million and would not affect revenues was false. It was apparent to senior management that the BBA would have a much greater impact on HealthSouth's earnings. Indeed, in March, 1999, the Company admitted that it decided in 3Q98 to discontinue its home health operations as a result of the BBA.

529. The Company's claims that its acquisition of NSC increased the likelihood that HealthSouth would increase its earnings estimates were blatantly false when made. As an initial matter, HealthSouth was not likely to meet estimates absent its fraudulent activities. In addition, HealthSouth's acquisition of NSC only increased the likelihood that HealthSouth could only post its numbers if HealthSouth extended its fraudulent practices to the newly acquired company.

#### **False and/or Misleading Statements Issued During the Third Quarter of 1998**

530. On July 2, 1998, *The Wall Street Journal* reported on HealthSouth entitled "HealthSouth Purchases 33 Clinics." HealthSouth Corp. said it completed the purchase of 33 ambulatory-surgery clinics from Columbia/HCA Healthcare Corp., Nashville, Tenn., for approximately \$500 million. The purchase increases to more than 250 the number of outpatient clinics HealthSouth operates.

531. During the week of July 20, 1998, HealthSouth completed the acquisition of NSC by issuing 21,426,626 shares of HealthSouth stock in exchange for 18,617,279 shares of NSC stock and options to acquire 2,197,047 shares of HealthSouth stock in exchange for options to acquire 1,908,981 shares of NSC stock. In connection with the acquisition of NSC, HealthSouth issued the NSC Registration Statement (including the NSC Proxy/Prospectus) which (i) included material portions of the financial statements of HealthSouth for 1997 and previous years and specifically incorporated by reference, among other documents, the 1997 Form 10-K and the First Quarter 1998 Form 10-Q; and (ii) stated, among other things:

Substantially all of HEALTHSOUTH's revenues are derived from private and governmental third-party payors (in 1997, approximately 36.9% from Medicare and approximately 63.1% from commercial insurers, managed care plans, workers' compensation payors and other private pay revenue sources). There are increasing pressures from many payer sources to control healthcare costs and to limit increases in reimbursement rates for medical services. There can be no assurances that payments under governmental and third-party payor programs will remain at levels comparable to present levels. In attempts to limit the federal budget deficit, there have been, and HEALTHSOUTH expects that there will continue to be, a number of proposals to limit Medicare reimbursements for certain services. HEALTHSOUTH cannot now predict whether any of these pending proposals will be adopted or, if adopted and implemented, what effect such proposals would have on HEALTHSOUTH.

532. The NSC Registration Statement was false and misleading because, as described in detail herein, HealthSouth's revenues, earnings and assets were materially overstated, and HealthSouth's business and prospects were already being materially impacted by the BBA.

533. On July 21, 1998, HealthSouth issued its Second Quarter 1998 results, as described in Appendix 2, including earnings per share of \$0.28.

534. Between July 20, 1998 - July 27, 1998, HealthSouth's shares fell by approximately 15.5%. As a result, analyst Chiarelli of J.P. Morgan called HealthSouth on or about July 21, 1998 and spoke extensively with its management, including defendants Scrushy and Martin. During those extensive conversations, defendants Scrushy and Martin falsely stated:

- The decline in HealthSouth's shares had no basis in fact and was not due to any fundamental reason.
- They expected HealthSouth to achieve EPS of \$0.30, \$0.31 and \$1.15 in third quarter 1998, fourth quarter 1998 and 1998, respectively.
- The Company continued to experience solid increases in same-store sales growth in all of its divisions.
- The Company expected strong internally generated growth through 1999 and, as a result, it would have no difficulty in achieving EPS of \$1.40 (or 21% growth over 1998).

535. On July 22, 1998, J.P. Morgan issued a report on HealthSouth based on Scrushy's and Martin's statements. The report rated HealthSouth a "buy," contained EPS forecasts of \$1.16 for 1998 and \$1.40 for 1999 and stated:

*We have had [sic] spoken extensively with management and feel confident that there are no issues regarding the company's Medicare billing practices, and we do not believe the company would acquire operations which are inconsistent with current operations and earnings growth. In our discussion with management, we reviewed acquisitions made over the past five years, and we are comfortable that there are no issues that could prompt a Federal investigation regarding Medicare billing practices. ... Same-facility growth continues to drive revenue. The company continues to experience solid increase in same-facility growth in all of its divisions.*

536. Between July 27, 1998 and August 14, 1998, the price of HealthSouth stock remained particularly weak. As a result, analyst Sullivan of Cowen & Co. contacted HealthSouth and spoke with its management, including defendants Scrushy and Martin. During those conversations, which occurred on August 13, 1998, Scrushy and Martin falsely stated:

- HealthSouth was not being adversely impacted by HMOs' efforts to obtain price reductions.
- HealthSouth had already negotiated discounted fees in exchange for volume contracts and HealthSouth, given its cost advantage, would not be adversely impacted.
- There was no change in operating trends at HealthSouth.

537. Between August 4, 1998 and August 14, 1998, analyst Rice of Bear Stearns also had several conversations with HealthSouth management, including defendants Scrushy and Martin,

regarding the weakness in HealthSouth's share price. During those conversations, defendants Scrushy and Martin falsely stated:

- There had been no change in the favorable fundamentals enjoyed by HealthSouth.
- ***The operating trends at HealthSouth had changed little*** from the 23% increase in EPS HealthSouth achieved in second quarter 1998.

538. Between July 27, 1998 through and including September 13, 1998, analyst Chiarelli of J.P. Morgan spoke extensively with HealthSouth's management, including defendants Scrushy and Martin, in private one-on-one conversations. During those conversations, defendants Scrushy and Martin falsely stated:

- The decline in HealthSouth's shares had no basis in fact and was not due to any fundamental reason.
- They had the conviction that HealthSouth would achieve \$0.30, \$0.31 and \$1.15 EPS in third quarter 1998, fourth quarter 1998 and for the full-year 1998, respectively.
- The Company continued to experience solid increases in same-store sales growth in all of its divisions.
- The Company expected strong internally generated growths through 1999 and, as a result, it would have no difficulty in achieving EPS of \$1.40 (or 21% growth over 1998).

539. On August 14, 1998, Bear Stearns issued a report on HealthSouth by Rice & Gallucci, based on statements by HealthSouth management. The report, rating HealthSouth a "BUY," contained EPS forecasts of \$1.16 for 1998 and \$1.40 for 1999 and stated:

We have had several conversations with management over the last 10 days, and we believe that there has been no change in the favorable fundamentals enjoyed by the company.... HRC posted a 23% increase in EPS during the second quarter, and we believe that the company will post a similar rate of increase for all of 1998.

540. On September 14, 1998, analyst Rice of Bear Stearns spoke with management at HealthSouth, including defendants Scrushy and Martin, regarding the Bear Stearns Healthcare Conference to be held the week of September 21, 1998, at which defendant Scrushy was scheduled to speak on September 25, 1998. During those private one-on-one conversations, defendants

Scrushy and Martin told Rice that HealthSouth's management was frustrated with the recent sell-off in HealthSouth's stock, and Scrushy would address the concerns of investors at the conference. During the September 25, 1998 Conference, which was attended by numerous securities analysts, Scrushy falsely stated that he was confident in the Company's ability to achieve analysts earnings expectations of \$0.30, \$0.31 and \$1.15 for third quarter 1998 and fourth quarter 1998 and 1998, respectively.

541. Defendant Citi/Salomon also issued positive but false reports about HealthSouth during the Quarter 1998, as described in Appendix 7.

542. On September 29, 1998, HealthSouth's stock price began to collapse, falling from \$18-3/8 to \$14-5/8, as HealthSouth began to communicate to analysts that it might miss analysts' EPS estimates for third quarter 1998, fourth quarter 1998, 1998 and 1999. Then, on 9/30/98, HealthSouth revealed, in stark contrast to the numerous positive statements defendant Scrushy and HealthSouth management made that:

(a) It was continuing to see pressure from major managed care firms to renegotiate existing contract terms;

(b) Defendant Scrushy stated it was "being pressured by payers to renegotiate rates and [was] seeing delays in payment under current contracts;"

(c) As a result, HealthSouth could no longer grow its earnings at the historical 20%-25% rate but only a 15%-20% rate going forward; and

(d) As a result, HealthSouth might miss "analysts" earnings estimates in 1998 and 1999.

543. Defendant Scrushy stated: "If we determine that market estimates are out of line with our internal expectations, we will reverse our guidance to the investment community. Until we have

completed that process, we believe it is premature to comment on our expectations for the coming months.” Scrushy did, however, admit: “[W]e think there will be some adjustment.”

544. These disclosures caused HealthSouth stock to continue to drop to \$10-½ and the price of HealthSouth’s 3.25% convertible subordinated debentures declined to approximately 20% below the price at which they were offered.

545. Defendants promptly responded with additional false statements to boost the price of HealthSouth shares. On September 30, 1998, HealthSouth announced over the PR Newswire a stock buy back. The release quotes Scrushy as saying of the stock buy back: “HealthSouth’s management and Board of Directors believe that the current trading price of our stock does not reflect appropriate value for our strong fundamentals or our results of operations, .... We believe that, at existing market levels, this repurchase represents an excellent use of our capital and an opportunity to enhance value for our shareholders.”

#### **Reasons Defendants’ Statements Issued During the Third Quarter of 1998 Were False and/or Misleading**

546. The statements identified above and in Appendices 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the company as described in detail herein.

547. The statements relating to HealthSouth’s financial and operational reporting for this time period were false and misleading including Scrushy and Martin’s claims that no fundamental reason existed to support a decline in the value of HealthSouth’s shares.

548. Defendants’ affirmative denial of engaging in practices that could prompt a federal investigation, repeated by analysts, was patently false. As discussed above, HealthSouth was engaging in deliberate acts to defraud Medicare.

549. The SARC reported that HealthSouth’s second quarter 1997 income, before taxes and minority interest, was overstated due to improper adjustments by \$127.17 million. Defendants’

statements relating to revenue growth, projected EPS, etc. were false and misleading because they were without basis and based on false financials already in the marketplace.

550. The statements by Scrushy and others at the company slightly lowering the Company's projected earnings were false and misleading in that the new projections also failed to acknowledge the company's past and ongoing fraudulent practices with regard to cooking the books, as well as fraudulently seeking Medicare reimbursement and pushing to acquire more companies with the intended purpose of burying costs by writing off assets following those acquisitions. Finally, defendants continued to deny the full impact of the BBA on their operations.

**False and/or Misleading Statements Issued During the Fourth Quarter of 1998**

551. On October 14, 1998, SG Cowen Securities issued a report on HealthSouth by Cederlund, Miner & MacDonald, written after discussions with Scrushy and Martin which was based on and repeated information provided by them. The report stated:

- \$300MM Shortfall From Previous Expectations - HRC management stated that its estimate of the pretax shortfall in 1999 versus prior expectations is \$300MM. This is comprised of \$100MM from the impact of the Balanced Budget Act Of 1997 and \$200MM from a decline in same-store volume growth (down 1-2%) and rates (down 2-4%). The \$100MM hit from BBA 1997 was larger than most thought and is likely due to cuts in reimbursement for capital costs and bad debt, modest inpatient rehab cuts tied to lower target rates and incentive payments, and the termination of home health operations. Cost reductions of \$50MM included in the guidance could be the low point in a \$50-100MM range.

552. On October 27, 1998, HealthSouth announced its Third Quarter 1998 results as described in Appendix 2, including income per share of \$0.28.

553. On October 26, 1998, Dow Jones Online News issued a report on HealthSouth entitled "Analysts to Study Pricing, Same-Store Sales in HealthSouth Earnings" by Mark Yost.

Pricing and same-store sales are the key numbers analysts will look at when HealthSouth Corp. reports third-quarter earnings Tuesday.

"I'm going to be focused on any change in their posture related to managed-care pricing going into the January renewal period," said Jean Swensen, health-care

analyst for BT Alex. Brown Inc. in Boston. "I'll also be looking to what degree we start to see deterioration in volumes."

She also said she'll be looking at how many shares execs have purchased in a previously reported stock buyback plan.

HealthSouth's (HRC) earnings over the past few years have been driven by phenomenal same-store sales growth. But analysts expect growth to slow to 15%-20% from average growth of more than 30% over the past few quarters.

On Oct. 1 HealthSouth ... said it might have to lower its earnings estimates because its managed-health care clients are trying to negotiate lower rates.

According to a First Call survey of 11 analysts, HealthSouth ... is expected to report third-quarter earnings of 28 cents a share, compared with 24 cents a year ago. Swensen recently lowered her 1999 earnings estimate for HealthSouth to \$1.30 a share from \$1.40.

In an interview in The Wall Street Journal Oct. 1, HealthSouth Chief Executive Richard M. Scrushy said efforts by managed-care companies to pay lower rates to health-care providers are partly to blame for the uncertain earnings outlook for 1999. He also said HealthSouth couldn't sustain its 30% growth rate because it had gotten too big.

In addition to its earnings uncertainty, HealthSouth is expected to take a one-time, noncash \$100 million charge in the third quarter to close out its home-health-care business. Analysts termed the charge a "minor event," mainly because home health care is not one of HealthSouth's core businesses.

"Hindsight being 20-20, they probably should have taken the charge when they were taking gains a few quarters ago," said Swensen.

554. On October 29, 1998 the Chicago Tribune reported statements by Scrushy: "I think the market will realize it overreacted."

555. HealthSouth's stock recovered somewhat, due to defendants' favorable comments, to the \$12 range.

556. On December 4, 1998, the Business Journal-Sacramento reported statements by HealthSouth which acknowledged the severe impact of the BBA:

**HealthSouth** not only shuttered some 30 home health agencies last month, but it took a \$ 105 million charge on its third-quarter earnings related to the termination of this sector of the company's business. HealthSouth operates six surgery centers, eight rehabilitation centers and three occupational medicine clinics in the area.



“If you took a *\$100 million whack* from the federal government, you’d make changes, too,” said the company spokesman Vince Thompson.

557. Defendant Citi/Salomon also issued positive but false reports about HealthSouth during the Fourth Quarter 1998, as described in Appendix 7.

**Reasons Defendants’ Statements Issued During the Fourth Quarter of 1998 Were False and/or Misleading**

558. The statements identified above and in Appendix 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as described in this Complaint. The SARC reported that HealthSouth’s third quarter 1998 income, before taxes and minority interest, was overstated due to improper adjustments by \$167.17 million.

559. In addition, in November 1998, E&Y and the Company received the email from the “fleeced shareholder” who pointed directly to methods used by the Company to massage its numbers. E&Y only followed up regarding the fleeced shareholder memo verbally with HealthSouth’s General Counsel, and relied on HealthSouth to inform its audit committee. E&Y did not meet with HealthSouth’s audit committee to discuss the issues raised in the memo, yet E&Y concluded that the memo had no validity. Neither the company nor E&Y made these issues public, and E&Y’s investigation of the claims were woefully inadequate. The reason, of course, is that the Company and E&Y knew the claims were true and that the Company had been falsifying its financials for years.

560. Defendants’ repeated projections of continued same-store sales growth were premised on the Company’s past years of growth which were falsely reported. The projections going forward were thus also false.

561. Defendants’ claims that HealthSouth was reducing its estimates by \$100 million due to the BBA’s cuts in capital costs and bad debt were false and misleading in that the BBA had a much more severe impact in the Company’s revenues and operations.

562. Defendants' statements relating to the \$100 million charge to close out HealthSouth's home health care business were also false, in that this charge derived primarily from a need to cover up defendants' ongoing fraudulent activities.

**False and/or Misleading Statements Issued During the First Quarter of 1999**

563. On February 8, 1999, HealthSouth issued a press release entitled "HEALTHSOUTH Announces \$1 Billion Stock Repurchase Program And One-Time Charge In Fourth Quarter" saying that the company had completed its previously announced repurchase of 1,600,000 shares. Scrushy is quoted as saying, "Healthsouth's management and Board of Directors continue to believe that the current trading price of our stock does not reflect appropriate value for our strong fundamentals or our results of operations.... In this environment, we believe that the repurchase of our stock represents a prudent use of our strong cash flow and available working capital." See App. 2. Healthsouth also announced that it expected to report a one time charge of approximately \$310 million in the fourth quarter of 1998 relating to the value of certain assets obtained through the Company's major acquisitions. The day after this news was disclosed, HealthSouth's stock dropped 10.5% to \$13.31.

564. On March 4, 1999, HealthSouth announced operating results for the quarter and year ended December 31, 1998, as described in Appendix 2, including income per share of \$1.09 for 1998.

**Reasons Defendants' Statements Issued During the First Quarter of 1999 Were False and/or Misleading**

565. The statements identified above and in Appendix 2 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the company as described in this Complaint.

566. Defendants continued to falsify HealthSouth's numbers in order to public estimates and projections set by HealthSouth. Defendant Martin, CFO of HealthSouth during 1998 and 1999,

has now admitted that the financial and operational reports published by the Company and filed with the SEC were false and misleading and inflated to meet or exceed analysts' expectations.

567. Pursuant to this scheme, HealthSouth's 1998 year-end net income was overstated by \$550 million, and the Company's actual loss for 1998 was \$99 million. Thus, the Company's claim issued during the first quarter of 1999 that it met analysts' expectations for the year 1998, including same-store growth were similarly false and misleading. Without perpetrating its financial and operational fraud, HealthSouth could not have posted numbers that met analyst expectations. The SARC reported that HealthSouth's fourth quarter 1998 income, before taxes and minority interest, was overstated due to improper adjustments by \$208.47 million.

568. Defendant Scrushy's statements, on behalf of management and the Board, that the Company's re-purchase of 1,600,000 shares reflected their strong belief in the Company's fundamentals and results was false when made. In fact, the repurchase was intended solely to drive up the Company's stock price, regardless that the Company was engaging in massive fraud. Defendants' repeated statements that the stock price did not reflect the Company's strong fundamentals were also false, in that HealthSouth's fundamentals were falsely reported and were not strong.

569. The claim that the \$310 million charge was related to assets acquired through the Company's major acquisitions was false. In fact, the charge was necessary only to continue to cover up defendants' fraudulent activities. Moreover, the charge itself gave lie to defendants' earlier statements regarding the profitability of those companies at the time of acquisition.

570. As reflected in the Congressional testimony of certain Board members, in 1999 the Company failed to inform the public of the conflicts of interest of certain members of its Board of Directors, including the consulting contract between HealthSouth and the head of the Board's Compliance Committee.

## **False and/or Misleading Statements Issued During the Second Quarter of 1999**

571. In the Company's 1998 Form 10-K, HealthSouth finally admitted that its closure and write-down of its home health operations was a direct result of the BBA and not because they were "inconsistent with the Company's core business and growth strategy." The 10-K belatedly disclosed that during the third quarter of 1998, the Company had adopted a plan to dispose of or discontinue its home health operations. "The decision to adopt the plan was prompted in large part by the negative impact of the 1997 Balanced Budget Act (the 'BBA'), which placed reimbursement limits on home health businesses." *See* App. 2.

572. On April 27, 1999, HealthSouth announced operating results for its first quarter ended March 31, 1999, as described in Appendix 2, including income per share of \$0.26.

573. Defendants' misrepresentations in the April 27 Press Release, the follow-up conference call and the first quarter 1999 10-Q inflating HealthSouth's financial results repeatedly caused analysts to recommend the purchase of HealthSouth shares. For example, on April 27, 1999, BT Alex. Brown issued an analyst report rating HealthSouth a "BUY." Deutsche Bank stated, "[w]e believe that HRC has the ability to beat our 1999 estimate by \$0.01 to \$0.03 per share" and that "shares could trade up to the \$17 level."

574. Numerous analysts' reports were issued based on false information from HealthSouth's management. On April 28, 1999, BT Alex. Brown ("BT") issued a favorable report on HealthSouth. BT stated, "over the next 12 months, as visibility on the return to earnings growth improves, the shares could trade up to the \$17-20 level." Similarly, Salomon Smith Barney ("SSB") "reiterate[d] [its] 1H (Buy, High Risk) rating and [its] \$19 price target." D.A. Davidson & Co. issued a favorable report, stating "we believe the shares have further to go and we are maintaining our \$20 Basic Value (16 times our 2000 EPS estimate) and BUY rating for aggressive investors."

CIBC Oppenheimer issued an analyst report entitled “HEALTHSOUTH First Quarter Results Indicate Positive Momentum.”

575. On June 15, 1999, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders. During the call and in follow-up conversations with analysts Scrushy and Martin made the following false representations:

SCRUSHY: The proposed spin-off [to divide] the company into 2 separate public companies. It does isolate exposure to the MediCare reimbursement cloud that, we believe, will ultimately be very positive for the in-patient side of our business. And we think that the PPS proposal that we will see next year under the Balanced Budget Act Mandate will allow us, for the first time, to make a profit on MediCare patients in rehabilitation hospital industries.

As you know, we have a very cost-effective rehabilitation hospital business. We have the lowest cost in the nation on a per-case basis or per-discharge basis. It has positioned us very well, so that once the prospective payment program is put into place, we believe that our facilities will profit substantially.

\* \* \*

We do have an extensive compliance program that will continue in both sides -- both of these companies, that includes internal compliance officers, compliance hotline, and working very closely with internal audit departments, and external firms, such as our relationship with E&Y, and the Strategic Management Systems.

So, we think that our compliance program will remain strong and in place.

\* \* \*

RICHARD SCRUSHY: Yeah, for 1999, total cap ex, including development opportunities, will be somewhere in the neighborhood of \$500 million.

\* \* \*

MIKE MARTIN: Yeah. The maintenance cap ex is running between \$150 to \$250 million. That’s about 60% on the in-patient side, 40% on the out-patient side.

576. Banc of America Securities (“BAS”) issued an update on June 15, 1999 in which it maintained a price target of \$19 and a rating of “BUY.” BAS was encouraged by management’s endorsement of 20%+ earnings growth for outpatient operations, and wrote “[w]e believe HEALTHSOUTH is on track to meet our second quarter revenue estimate of \$1.05 billion, up 7% from the prior year, and our EPS estimate of \$0.27.”

577. Defendants UBS and Citi/Salomon also issued positive but false reports about HealthSouth during the Second Quarter 1999, as described in Appendices 2, 6 and 7.

**Reasons Defendants' Statements Issued During the Second Quarter of 1999 Were False and/or Misleading**

578. The statements identified above and in Appendices 2, 6 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as set forth in this Complaint.

579. Defendants' repeated statements relating to the stock repurchase program were false and misleading for the reasons set forth above.

580. Martin's statements relating to the Company's capital expenditures were false as the Company continued to engage in the practice of capitalizing expenses.

581. Defendants' claims that the inpatient side of defendants' business would make a profit for the company due to the PPS were false. Defendants' billing practices were premised on fraud. As a result, any accurate implementation of PPS would decrease HealthSouth's revenues.

582. Defendants' affirmative statements regarding its compliance system were untrue and contradicted by facts known at the time. In fact, HealthSouth's compliance system failed at every level: its audit committee was not independent, but rather was riddled with conflicts of interest; E&Y was not independent; the underwriters weren't doing their due diligence; the Company's compliance committee was not investigating meritorious claims that arose; internal audit didn't have access to the auditors and vice versa; and Scrushy and other members of top management could override accounting decisions.

583. As discussed above, defendants' forward-looking statements concerning cash flow, EPS, etc. going forward were false and misleading in that they were premised on input numbers which were false, and also because HealthSouth was engaging in widespread fraud to meet its

numbers. The SARC reported that HealthSouth's first quarter 1999 income, before taxes and minority interest, was overstated due to improper adjustments by \$85.43 million.

584. During this time frame, UBS Warburg issued its report recommending the stock to be a strong buy. Subsequent to issuing this report, defendant Capek issued reports referring to the stock as a "pig" and indicating that he personally would not own a share. Despite this, when Capek reinitiated coverage in February 2000, he once again rated the Company's stock a strong buy. Furthermore, prior to 2002, UBS was performing both banking and analyst functions for HealthSouth.

**False and/or Misleading Statements Issued During the Third Quarter of 1999**

585. On August 3, 1999, HealthSouth announced its Second Quarter results, as described in Appendix 2, including EPS of \$0.27.

586. Analysts responded favorably to HealthSouth's Second Quarter results. For example, on August 3, 1999, BAS issued a report entitled "Second Quarter EPS of \$0.27 In Line With Estimate," in which BAS maintained its "\$19 price target" and "rating of Buy." Similarly, on August 16, 1999, Bear Stearns stated that "the company's base business remains healthy, replete with a solid balance sheet and continuing market share gains" and "given our independent analysis of the value of each business line, we maintain that the company's private market value is in the low \$20 range."

587. Also on August 3, 1999, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders. During the call with analysts, Scrushy and Martin repeated the Company's financial results for the Second Quarter 1999, discussed the impact of the BBA and explained the reasons for dividing the Company's operations.

The transaction rationale accelerates earnings growth, out-patient growth prospects are very good. It adds potential in-patient growth opportunities. We basically have

limited the growth in the in-patient side of our business, and focused on the out-patient growth.

The in-patient is almost \$2 billion dollars' worth of our revenues, so not allowing that division to grow has certainly brought down our growth rate. By breaking these two companies apart and allowing the in-patient to grow on its own, as well as continuing to grow in the out-patient area, would give two companies higher growth rates.

588. Scrushy acknowledged the adverse impact of BBA:

HealthSouth, as you know, took a major – has made major reductions in its operations over the last few years to bring our cost structure in line with a system like this. We were penalized under the BBA significantly – continually penalized under the BBA, because once we lowered our cost, which also lowered our revenue – because, the way it works in a cost-based environment is that when you lower your cost that is your revenue. In a business that's 57% MediCare – the impact, then, has been that we were penalized, because they eliminated the incentives for bringing your costs down and, the BBA took that out, as well as our capital reimbursement.

589. On September 17, 1999, HealthSouth announced via PR Newswire share repurchases and management purchases. The report stated:

HEALTHSOUTH Corporation [NYSE: HRC] today announced that as of Thursday, September 16, it had acquired an additional 7,723,704 shares of HEALTHSOUTH Common Stock under its previously announced share repurchase plan, bringing the total number of shares repurchased under the plan to 15,234,804. In addition, the Company announced that Richard M. Scrushy, Chairman of the Board and Chief Executive Officer, had purchased 4,362,297 shares, James P. Bennett, President and Chief Operating Officer, had purchased 872,459 shares, and Michael D. Martin, Executive Vice President and Chief Financial Officer, had purchased 261,738 shares, while 16 other members of senior management had purchased an aggregate of 1,112,802 shares.

“In our announcement last week, we indicated our continuing belief that HEALTHSOUTH Common Stock is undervalued,” said Scrushy. “As we promised, HEALTHSOUTH has resumed active repurchases under its previously announced buyback program, and our management team has stepped forward to increase its investment in the company. At current price levels, the company expects to continue moving forward with the buyback program, and we believe that other officers of the company, along with many of our outside directors, will be in the market as well.”



### **Reasons Defendants' Statements Issued During the Third Quarter of 1999 Were False and/or Misleading**

590. The statements identified above and in Appendix 2 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as set forth in this Complaint.

591. The SARC reported that HealthSouth's second quarter 1999 income before taxes and minority interest was overstated due to improper adjustments by \$129.79 million.

592. The statements relating to HealthSouth's financial reporting for this time period continued to be false, HealthSouth continued to defraud Medicare, the BBA continued to severely impact the Company, and the statements about HealthSouth's stock being undervalued were known by senior management to be false when made by Scrushy.

593. Plaintiffs also incorporate by reference the reasons that defendants' previously issued statements were false and misleading as set forth above.

### **False and/or Misleading Statements Issued During the Fourth Quarter of 1999**

594. On November 3, 1999, HealthSouth announced its Third Quarter 1999 results, as described in Appendix 2, including income per share of \$0.16. These results were in line with analyst expectations.

595. On November 3, 1999, Scrushy participated in an interview on the CNBC television news show "Power Lunch." During that interview, Scrushy stated that "this quarter is a good example of sort of the margins that we should expect," referring to the 27%-28% margins announced by HealthSouth. He went on to represent falsely, "I think that's a very strong indication that this company's in excellent shape."

596. Defendant Citi/Salomon also issued positive but false statements about HealthSouth during the Fourth Quarter 1999, as described in Appendix 7.

### **Reasons Defendants' Statements Issued During the Fourth Quarter of 1999 Were False and/or Misleading**

597. The statements identified above and in Appendices 2 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as described in this Complaint.

598. These statements relating to HealthSouth's financial reporting for this time period were false and misleading as the "family" continued to falsify the financials. Specific statements relating to additional reserves related to accounts receivable were false and misleading in that they did not fairly disclose that defendants' reserves were inadequate and that defendants should be taking write-offs for past overdue accounts. The SARC reported that HealthSouth's third quarter 1999 income, before taxes and minority interest, was overstated due to improper adjustments by \$63.8 million.

599. Defendants' repeated statements relating to the stock repurchase program were false and misleading because, in fact, the stock was not undervalued; it was inflated due to defendants' fraudulent scheme.

600. Defendants' false and misleading forward-looking statements were false and misleading because defendants knew they were without basis and based in part on the cumulative false financials.

### **False and/or Misleading Statements Issued During the First Quarter of 2000**

601. In February 2000, Scrushy was interviewed by the Wall Street Transcript. Scrushy stated:

Mr. Scrushy: We believe that we can grow the company at about a 15%-plus growth rate.... *So yes, we will continue expanding the company and growing in those markets that we believe are strategic, long-term, for the company.*

\* \* \*

TWST: Could you comment on some risks or dangers or pitfalls that you may be facing and what you intend to do about them?

Mr. Scrushy: I think we've *been through the worst of it. We went through the Balanced Budget Act in 1997, and that was one we had to work through. That's over with; the budget has been balanced....*

\* \* \*

TWST: Could you comment on the mile-stones and yardsticks that the investor should be looking at over the next few years or how your performance would be judged?

Mr. Scrushy: *We believe that we should be looked at as a company that has the ability to have growth in the mid-to high teens....* So all of that together, along with the revenue growth and the ability to add these new facilities as well as some census increases, *we're going to feel very comfortable that we'll be able to see some nice growth in that range that I mentioned earlier. Actually, we expect 2002 earnings to exceed 2001 consensus by 39%, partly due to the positive impact from PPS for rehabilitation hospitals.*

\* \* \*

TWST: Would you summarize the principal reasons why the long-term investor should be interested in your company?

*We are in a very strong position to deal with the payers.* We are also in a very strong position in the markets we are in to deal with physicians. A great terms with a good track record. We struggled back when we had the introduction of the Balanced Budget Act. *The company had a little setback for a year or two there, but we have overcome that. The company has started ticking back up. The margins have started improving and our days of sales outstanding have improved since 1999. Our balance sheet continues to improve. Our pricing is improving. A lot of very positive things are happening.*

602. On March 7, 2000, HealthSouth announced its purported year-end 1999 and Fourth Quarter results, as described in Appendix 2, including 1999 income per share of \$0.85.

603. HealthSouth's 1999 Report to Shareholders contained a letter from Scrushy stating:

The Balanced Budget Act of 1997 and managed care cutbacks took a major toll on healthcare providers in 1998 and 1999. We have made many adjustments and *changes we believe will make sure our company continues to grow and prosper in the future. We do not believe our current stock price accurately reflects the current or future value of our company's network of facilities. We believe that our current initiatives will restore value to our stockholders.*

In 1999, we continued to feel the impact of the Balanced Budget Act of 1997, which sharply reduced incentive payments to cost-effective providers. We feel encouraged, however, that the Health Care Financing Administration's mandate to implement a prospective payment system (PPS) for inpatient, rehabilitation will occur with 12 months. ***PPS will actually reward cost-effective, well-managed providers such as HealthSouth with the opportunity to earn a margin on Medicare services.***

604. With respect to Medicare, HealthSouth's 1999 Annual Report stated (as it did in its 1998 Annual Report):

The healthcare industry is subject to regulation by federal, state and local governments. The various levels of regulatory activity affect our business activities by controlling ... the reimbursement to HEALTHSOUTH for services provided.

\* \* \*

In order to participate in the Medicare program and receive Medicare reimbursement, each facility must comply with the applicable regulations of the United States Department of Health and Human Services .... We have developed our operational systems to attempt to assure compliance with the various standards and requirements of the Medicare program and have established ongoing quality assurance activities to monitor compliance.

\* \* \*

Over the past several years an increasing number of healthcare providers have been accused of violating the federal False Claims Act. That Act prohibits the knowing presentation of a false claim to the United States government. Because HEALTHSOUTH performs thousands of similar procedures a year for which it is reimbursed by Medicare and there is a relatively long statute of limitations, a billing error or cost reporting error could result in significant civil or criminal penalties.

605. Defendants UBS and Citi/Salomon also issued positive but false reports about HealthSouth during the First Quarter 2000, as described in Appendices 2, 6 and 7.

#### **Reasons Defendants' Statements Issued During the First Quarter of 2000 Were False and/or Misleading**

606. The statements identified above and Appendix 2 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as specified throughout this Complaint.

607. Defendants continued to falsify HealthSouth's numbers in order to meet public estimates and projections originally set by the Company. Defendant Martin, CFO of HealthSouth through February 2000, and defendant Owen, CFO from February 2000 through 2001, have now admitted that the financial and operational reports published by the Company and filed with the SEC were false and misleading and inflated to meet or exceed analysts' expectations.

608. Pursuant to this scheme, HealthSouth's 1999 year-end net income was overstated by \$350 million, and the Company's actual loss for 1999 was \$283 million. Thus, the Company's claims issued during the first quarter of 2000 that it met analysts' expectations, including same-store growth, were similarly false and misleading. The SARC reported that HealthSouth's fourth quarter 1999 income before taxes and minority interest was overstated due to improper adjustments by \$123.94 million. Without perpetrating its financial and operational fraud, HealthSouth could not have posted numbers that met analyst expectations.

609. Defendant Scrushy's statements relating to the BBA indicating that HealthSouth overcame the problems with the BBA and referring to the positive impact of PPS were false, in that HealthSouth's margins had not improved and PPS did not have a positive impact for the Company. References to HealthSouth as a cost-effective provider were also misleading, in that HealthSouth managed to control its costs by manipulating its accounting and the Medicare system.

610. Defendants' repeated projections of continued same-store sales growth were premised on the Company's past years of growth which were falsely reported. The projections going forward were thus also false. This includes defendant Scrushy's statements that the Company expected 2002 earnings to exceed the 2001 consensus by 39% due to the positive impact of PPS.

611. HealthSouth's statements concerning the False Claims Act were false or misleading. As described above, defendants deliberately misreported the services provided by making entries with the wrong billing codes. Several *qui tam* actions filed in 1998 were based on the testimony of

former HealthSouth patients, who claimed that HealthSouth improperly charged for individual therapy when performing group therapy. For example, on April 24, 1998, James Devage, a former HealthSouth patient, filed an action in federal district court against HealthSouth alleging that HealthSouth knowingly and fraudulently overcharged Medicare, including improperly charging for individual therapy when the services performed were actually group therapy. Similarly, in 1998, Manning and others alleged that HealthSouth had submitted false Medicare claims beginning in 1995.

**False and/or Misleading Statements Issued During the Second Quarter of 2000**

612. On April 24, 2000, HealthSouth announced its First Quarter 2000 results, as described in Appendix 2, including earnings per share of \$0.17.

613. Analysts responded favorably to HealthSouth's report of strong financial results and positive statements on the conference call (*see* App. 2). For example, on April 20, 2000, Olde issued an analyst report on HealthSouth "upgrading shares in HRC to ACCUMULATE from NEUTRAL." Similarly, on April 25, 2000, Deutsche Banc Alex. Brown initiated coverage of HealthSouth with a "BUY" rating. The report stated that "HEALTHSOUTH's near-term growth prospects are considerably brighter based on an anticipated improvement in operating margin throughout 2000, stabilized volume and pricing trends, and accelerated receivable collections."

614. Defendants UBS and Citi/Salomon issued positive but false reports about HealthSouth during the Second Quarter of 2000, as described in Appendices 2, 6 and 7.

**Reasons Defendants' Statements Issued During the Second Quarter of 2000 Were False and/or Misleading**

615. The statements identified above and in Appendices 2, 6 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company, as stated herein, as the "family" continued to falsify the financials. The SARC reported that

HealthSouth's first quarter 2000 income, before taxes and minority interest, was overstated due to improper adjustments by \$25.4 million.

616. Defendants' references to improvements in their collections cycle were misleading in that they did not disclose the extent of their uncollectible receivables and failed to write-off impaired assets as required by GAAP.

617. Defendants' statements regarding the Company's costs equaling their revenue under Medicare and that PPS would allow them to have a better margin were false and misleading because they failed to disclose that HealthSouth masked its costs through fraudulent activities.

**False and/or Misleading Statements Issued During the Third Quarter of 2000**

618. On July 17, 2000, HealthSouth announced on the PR Newswire that Bennett had resigned as President and Chief Operating Officer of HealthSouth. Scrushy said that HealthSouth's three division presidents would report directly to him until Bennett was replaced.

619. On July 18, 2000, HealthSouth announced operating results for the Second Quarter 2000, as described in App. 2, including earnings per share of \$0.17, consistent with Wall Street estimates.

620. Promptly following the release of the July 18, 2000 press release, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders.

621. On July 25, 2000, Deutsche Banc Alex. Brown released an updated report on HealthSouth entitled "Strong Pricing and Volume Trends Drive 2Q00 EPS of \$0.17, In Line with Street." The report, based on HealthSouth management's statements, reiterated a "BUY" rating based on HealthSouth's reported Second Quarter 2000 earnings "in line with the Wall Street consensus estimates for the period."

### **Reasons Defendants' Statements Issued During the Third Quarter of 2000 Were False and/or Misleading**

622. The statements identified above and in Appendix 2 were false and misleading because they failed to reveal and/or contradicted the true state of affairs at the Company, as set forth herein, in that the “family” continued to fill in the “dirt” and top management masked operational problems. The SARC reported that HealthSouth’s second quarter 2000 income, before taxes and minority interest, was overstated due to improper adjustments by \$51.27 million.

623. Defendants’ reference to declining DSOs was false and misleading. Further, the continued discussions of repurchasing the stock was intended solely to drive up the Company’s stock price, regardless that the Company was engaging in massive fraud. Defendants’ repeated statements that the stock price did not reflect the Company’s strong fundamentals was also false, in that HealthSouth’s fundamentals were falsely reported and were not “strong.”

### **False and/or Misleading Statements Issued During the Fourth Quarter of 2000**

624. On October 31, 2000, HealthSouth announced operating results for the Third Quarter 2000, as described in Appendix 2, including earnings per share of \$0.18.

625. That same day, Citi/Salomon issued a report on HealthSouth entitled “HRC: 3Q00: SUSTAINED IMPROVEMENT IN PROFITABILITY AND FINANCIAL POSITION.” The report issued a “revised price target” of \$15 up from \$12, and maintained HealthSouth’s 1H “Buy” rating.

626. On November 2, 2000, Scrushy was interviewed by the CNBC financial news program. When asked if he was pleased with HealthSouth’s earnings of \$0.18 compared to \$0.16 a year ago, Scrushy replied:

Very pleased. We have had a great quarter and as you compare to last year, the revenues are up, earnings are up, margins are up. We paid down a substantial amount of debt. We have been able to bring our day sales outstanding down so we had an excellent quarter. Volumes were up across the board in all business segments and we saw good strong price increases. So we are very pleased.



### **Reasons Defendants' Statements Issued During the Fourth Quarter of 2000 Were False and/or Misleading**

627. The statements identified above and in Appendix 2 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as detailed herein.

628. The SARC reported that HealthSouth's third quarter 2000 income, before taxes and minority interest, was overstated due to improper adjustments by \$113.84 million.

629. Defendants' claims that recent legislation was positive for the Company were patently false and misleading. Although defendants claimed to continue to reduce costs, its actual costs were masked by defendants' fraud.

### **False and/or Misleading Statements Issued During the First Quarter of 2001**

630. On January 10, 2001, Citi/Salomon raised HealthSouth's price target to \$21 up from \$15 and maintained its 1H "Buy" rating. The following week, on January 18, 2001 Jefferies & Co., Inc. initiated coverage of HealthSouth with a "BUY" rating "and a \$22 per share price target" based on "enviable unblemished earnings growth and stock price appreciation."

631. On March 6, 2001, HealthSouth announced its 2000 results, as described in Appendix 2, including earnings per share of \$0.71.

632. On March 6, 2001, Scrushy appeared on the CNBC financial news show "Squawk Box" to discuss the success of HealthSouth. Scrushy stated:

[Q]uarter to quarter each quarter over last year we have shown very healthy growth. Our revenues are up. Our pricing has stabilized. About 35 percent of our contracts now have shown some pricing increase. Our volumes are up all across the board and our 2000 plus facilities are doing quite well. So this has been a very good year for us. We've come back strong.

633. HealthSouth's 2000 Annual Report to Shareholders contained a letter from Scrushy stating:

In 2000, our stock rose to promising heights, closing up 203 percent for the year .... We also fulfilled Wall Street expectations for yet another year, maintaining

our position as the *Fortune 500* company with the second-longest streak for meeting or exceeding analysts' expectations.

634. HealthSouth's 2000 Annual Report also contained false financial data for the years 1996 through 2000. *See* App. 2.

635. With respect to Medicare, HealthSouth's 2000 Annual Report stated again that HealthSouth had developed operational systems to attempt to assure compliance with the various standards and requirements of the Medicare program and had established ongoing quality assurance activities to monitor compliance.

636. Defendants UBS and Citi/Salomon also issued positive but false reports about HealthSouth during the First Quarter 2001, as described in Appendices 2, 6 and 7.

**Reasons Defendants' Statements Issued During the First Quarter of 2001 Were False and/or Misleading**

637. The statements identified above and in Appendices 2 6 and 7 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as detailed in this Complaint.

638. Defendants deliberately falsified HealthSouth's numbers in order to meet public estimates and projections. Defendant Owen, CFO of HealthSouth from February 2000 until August of 2001, and defendant Smith, CFO from August 2001 to August 2002, have now admitted that the financial and operational reports published by the Company and filed with the SEC were false and misleading and inflated to meet or exceed analysts' expectations.

639. Pursuant to this scheme, HealthSouth's 2000 year-end net income was overstated by \$390 million, and the Company's actual net loss for 2000 was \$160 million. The SARC reported that HealthSouth's fourth quarter 2000 income, before taxes and minority interest, was overstated due to improper adjustments by \$158.44 million. Thus, the Company's claims issued during the First Quarter 2001 that it met analysts' expectations were similarly false and misleading. Without

perpetrating its financial and operational fraud, HealthSouth could not have posted numbers that met analyst expectations.

640. Defendant Scrushy's statements that the Company had fully recovered from the passage of the BBA were false and misleading in relying on the Company's supposed run-rate, which was calculated based on the Company's falsified accounting records. Scrushy's calculations regarding PPS were similarly flawed because they relied on the assumption that HealthSouth's costs were low.

641. Defendants' public statements were also false and misleading for failing to address the fraudulent Medicare practice associated with fraudulent billing. By 2001, physical therapists within HealthSouth were actively questioning senior management about the Company's practice of billing for individual therapy when group therapy was provided. Despite this, the Company continued to bill Medicare improperly for individual therapy, to charge for inadequately trained personnel, and to charge for services not rendered.

**False and/or Misleading Statements Issued During  
the Second Quarter of 2001**

642. On April 26, 2001, HealthSouth announced First Quarter 2001 financial results, as described in Appendix 2, including earnings per share of \$0.19, consistent with consensus Wall Street estimates.

643. On April 26, 2001, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders. During the call, Scrushy reiterated the financial results announced in HealthSouth's press release of the same day. See App. 2. Scrushy also said that "as far as inpatient PPS -- we still remain well-positioned as a low-cost efficient provider. Our current cost -- as we mentioned in other presentations -- continue to be well below the \$9,600 mark."

644. On April 26, 2001 Citi/Salomon issued an analyst report entitled “HRC: NO SURPRISES EQUALS GOOD 1Q01 FOR HEALTHSOUTH.” Based on “reported 1Q01 EPS of \$0.19 versus \$0.17 in the year ago quarter, in line with the consensus estimate” Salomon maintained a “price target” of \$21 per share and a 1H rating.

645. In an April 27 report, Jefferies & Co. maintained its “Buy” rating on HealthSouth with a \$22 per share price target. The report stated, “[f]irst quarter results were in line with Street expectations of \$0.19 per share versus \$0.17 a year ago.... The quarter’s results reinforce our initial investment thesis, which is that the company’s base businesses have stabilized and are showing signs of operational and financial improvement.” In addition, Lehman Brothers initiated coverage of HealthSouth with a “Strong Buy” rating; Merrill Lynch maintained a “Long Term Buy” rating.

646. On June 28, 2001, HealthSouth issued a press release announcing it was comfortable with second quarter earnings estimates. Owens confirmed that “HEALTHSOUTH is comfortable with analysts’ consensus earning estimates of \$0.20 per share for the second quarter ending June 30, 2001.... [T]he company continues to expect EPS growth in the 15% range for the next three to five years.”

**Reasons Defendants’ Statements Issued During  
the Second Quarter of 2001 Were False and/or Misleading**

647. The statements identified above and in Appendices 2 and 6 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as detailed in this Complaint.

648. Defendants’ claims regarding the Company’s first quarter 2001 results, PPS, its capital expenditures and its projections were all false and misleading because they were based on defendants’ cumulative false financials. The SARC reported that HealthSouth’s first quarter 2001 income, before taxes and minority interest, was overstated due to improper adjustments by \$60.53 million.

649. Defendants' affirmative statements regarding PPS audits compliance system were untrue and contradicted by facts known at the time. In fact, HealthSouth's compliance system failed at every level: its audit committee was not independent but was riddled with conflicts of interest; E&Y was not independent; the underwriters weren't doing their due diligence; the Company's compliance committee was not investigating meritorious claims that arose; internal audit didn't have access to the auditors and vice versa; and Scrushy and other members of top management could override accounting decisions.

650. Defendants' claim that HealthSouth reduced its indebtedness due to disciplined financial policies was false and misleading, in that HealthSouth was able to pay down its debt only by committing fraud, and that its financial policies were not disciplined.

**False and/or Misleading Statements Issued During  
the Third Quarter of 2001**

651. On July 31, 2001, HealthSouth announced its Third Quarter results, as described in Appendix 2, including earnings per share of \$0.21, beating consensus Wall Street estimates and representing an increase of 24% EBITDA margin.

652. On September 19, 2001, HealthSouth issued a press release confirming earnings estimates (the "September 19 Press Release"). In the September 19 Press Release, Scrushy stated, "[w]hile these events [of '9/11'] have caused some disruption for us, as they have for everyone, we do not foresee any EPS impact on our business."

653. Defendants UBS and Citi/Salomon also issued positive but false reports about HealthSouth during Third Quarter 2001, as described in Appendices 6 and 7.

654. On October 22, 2001, *The Investment Dealers' Digest* published an article entitled "Issuer Spotlight HealthSouth's post-Sept. 11 deal defies the odds." The article highlighted HealthSouth's recent private placement of \$600 million in new bonds. Responding to the deal, Tad

McVay, treasurer of HealthSouth, stated, “[w]e are headed in a positive direction, no question.... There is no credit criteria that we have not improved on in the last 18 months.”

**Reasons Defendants’ Statements Issued During  
the Third Quarter of 2001 Were False and/or Misleading**

655. The statements identified above and in Appendix 2 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company, including statements relating to HealthSouth’s financial reporting, defendants’ claims regarding PPS, defendants’ forward-looking statements based on the false cumulative financials, and projections for the Company’s capital expenditures and DSOs. The SARC reported that HealthSouth’s second quarter 2001 income, before taxes and minority interest, was overstated due to improper adjustments by \$228 million.

**False and/or Misleading Statements Issued During  
the Fourth Quarter of 2001**

656. On October 25, 2001, HealthSouth announced its Third Quarter results, as described in Appendix 2, including earnings per share of \$0.20, consistent with consensus Wall Street estimates and representing an increase of 11%, and the EBITDA margin was 27.7%.

657. On December 12, 2001, HealthSouth released its 2002 earnings objectives, raising its expectations for 2002 earnings per share to \$1.14 due to the expected effects of changes in government reimbursement practices and changes in the accounting for goodwill and intangible assets. Defendant Scrushy was quoted in the press release as stating:

The guidance on HEALTHSOUTH’s earnings objectives set forth above is based on current budget goals and HEALTHSOUTH’s assessment of current conditions affecting its business.... HEALTHSOUTH expects to update such guidance to reflect any material changes in its expectations and objectives if and when it determines that it is necessary or desirable to do so.

658. This guidance was reiterated, in various forms, a number of times over the following four months.

659. On December 12, 2001, Jefferies & Co. issued an analyst report entitled “HRC: 2002 Guidance Reassuring and Probably Conservative.” The report stated:

We believe guidance is reassuring, falling in line with our expectations for PPS upside, and, judging from our conversations with management, conservative to allow room for adjustment to the new reimbursement system. As the company reports consistent results, and very likely upside, in 2002, we expect multiple expansion for the stock. We have raised our 2002 EPS estimate to \$1.14 from \$0.91 and established a 2003 EPS estimate of \$1.33.

660. Defendant UBS also issued positive but false reports about HealthSouth during the Fourth Quarter 2001, as described in Appendix 6.

**Reasons Defendants’ Statements Issued During  
the Fourth Quarter of 2001 Were False and/or Misleading**

661. The statements identified above and in Appendices 2 and 6 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the Company as detailed herein.

662. The statements relating to HealthSouth’s financial and operational reporting for this time period were false and misleading, as were defendants’ claims that they had improved on every credit criteria. The SARC reported that HealthSouth’s third quarter 2001 income, before taxes and minority interest, was overstated due to improper adjustments by \$120.04 million.

**False and/or Misleading Statements Issued During  
the First Quarter of 2002**

663. On January 14 and 22, 2002, HealthSouth issued separate press releases reiterating their earnings per share estimate of \$1.14 for 2002. Scrushy stated, “[w]e remain comfortable with our 2002 earnings per share guidance of \$1.14, which represents a 39% increase over consensus estimates for 2001.” Scrushy also represented that “[w]e remain very excited about the change from cost-based reimbursement to PPS. HEALTHSOUTH has been an outspoken advocate of PPS in congressional and regulatory circles for some time.”

664. On March 12, 2002, HealthSouth announced year-end and quarter results, as described in Appendix 2, including 2001 earnings per share of \$0.82.

665. Defendants UBS and Citi/Salomon also issued positive but false reports about HealthSouth during First Quarter 2002, as described in Appendices 6 and 7.

**Reasons Defendants' Statements Issued During the First Quarter of 2002 Were False and/or Misleading**

666. The statements identified above and in App. 2 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the company due to the cumulative effect of the false quarterly financials as detailed in the Complaint.

667. Defendants continued to falsify HealthSouth's numbers in order to meet public estimates and projections originally set by the Company. Defendant Smith, CFO of HealthSouth during the first and second quarters of 2002, has now admitted that the financial and operational reports published by the Company and filed with the SEC while he was CFO were false and misleading and inflated to meet or exceed analysts' expectations.

668. Pursuant to this scheme, HealthSouth's net income for 2001 was overstated by \$450 million, and the Company's actual loss for 2001 was \$16 million. The SARC reported that HealthSouth's fourth quarter 2001 income, before taxes and minority interest, was overstated due to improper adjustments by \$167.46 million. The Company's claims that it met analysts' expectations, including same-store growth and positive pricing trends were similarly false and misleading. Without perpetrating its financial fraud, HealthSouth could not have posted numbers that met analyst expectations.

669. Defendants' claims that the PPS implementation was going extremely well and reimbursement was exactly as projected were false. The financial results reported in the March 12 Press Release were artificially and materially inflated due to the Company's systematic implementation of the financial fraud and the overbilling of Medicare and other payors through



upcoding of group therapy sessions and the other improper billing practices described herein. Similarly, the ““commit[ment] to ... strong financial performance in 2002”” was also predicated upon a continuation of inflated billings to the Government.

670. The representations on the March 12 conference call were materially false and misleading as Scrushy knew; HealthSouth’s reported and projected earnings and EBITDA margins were predicated on the financial fraud which had transformed a \$16 million loss for 2001 into a reported pretax profit of \$434 million. Moreover, HealthSouth was continuing to engage in upcoding and other improper Medicare billing practices to further inflate artificially the Company’s revenues, earnings, and margins.

671. Defendants’ claims to have developed an operational system that assured compliance with the Medicare program was ludicrous in the face of defendants’ flagrant violation of Medicare regulations through upcoding. In August of 2002, the Board discussed the effect of Transmittal 1753, but was first informed that the rule would cost the company only \$15-20 million, notwithstanding that Transmittal 1753 was a mere reiteration of a long-standing rule observed by HealthSouth’s competitors. Within a few weeks, however, HealthSouth announced that it would be required to take a charge of \$175 million. In fact, this was simply part of defendants’ attempt to cover up the massive fraud that HealthSouth had been perpetrating for years.

672. As part of that same cover-up, defendants shredded documents tying defendant Scrushy to knowledge of the effect of Transmittal 1753 prior to August, 2002. On September 26, 2002, Fulbright attorneys reviewing documents on the fifth floor of HealthSouth’s headquarters in the executive tower noticed shredders containing portions of documents which appeared to relate to the effect of Transmittal 1753 and which tied defendant Scrushy to knowledge prior to his trades in May, 2002. On October 2, 2002, Fulbright attorneys, despite their ongoing investigation, again noticed a HealthSouth employee shredding documents.

673. In October 2002, the company issued a press release announcing that Fulbright & Jaworski had cleared Scrushy of knowledge of the effect of Transmittal 1753. Yet Congressional testimony shows that the report had not cleared Scrushy of knowledge and that the memo's author was dismayed by the contents of the press release when issued, and asked that a corrective release be issued. HealthSouth's press release also failed to note that the original Fulbright & Jaworski report referred to the shredded documents found on the fifth floor in the executive tower where Scrushy worked, but this reference was deleted at Scrushy's request.

674. The representations in the 2001 Form 10-K (App. 2) were materially false and misleading in that the Company's "operational systems" were systematically circumvented through the financial fraud and were designed to overcharge Medicare and other payors through upcoding and other improper billing practices, not "to assure compliance with the various standards and requirements of the Medicare program." Similarly, the Company was engaged in a concerted effort to avoid rather than "assur[e] ... compliance," with the Government's billing procedures.

#### **False and/or Misleading Statements Issued During the Second Quarter of 2002**

675. On May 2, 2002, HealthSouth announced its First Quarter 2002 results, as described in App. 2, including earnings per share of \$0.27, consistent with consensus Wall Street estimates, and an EBITDA margin of 29.1%. In a conference call with analysts, Scrushy said he was "very comfortable" with analyst estimates of 39% profit growth in 2002.

676. Also on May 2, 2002, Scrushy was interviewed on CNBC concerning HealthSouth's financial condition and stock price. In the interview, when asked by CNBC anchor Ted David, "Where do you see your company fairly valued?" defendant Scrushy answered:

Well, *I think the company should be north of \$20* a share right now. I mean certainly we should trade at our growth rate. And we should trade, you know, our company has a, you know, strong cash flow. You know, we, certainly we should be higher than we are now. *I would expect to see the company in the 20s, and that's [where] we're headed*, we believe.

677. Defendants' numerous misrepresentations on May 2 had their intended effect. In response to those representations, HealthSouth shares rose on that day to a high of \$15.90 per share. Yet, the foregoing representations, among others, that (a) the price of HealthSouth shares should be "north of \$20 a share right now;" (b) HealthSouth shares "certainly ... should trade at our growth rate;" (c) the Company was experiencing "strong cash flow;" (d) HealthSouth's stock price "certainly should be higher than we are now;" and (e) the Company's stock price was "headed" into the "20s," were materially false and misleading. Defendants knew, or were reckless in not knowing, that the financial fraud and the systematic upcoding and other improper billing practices at HealthSouth had been artificially inflating the Company's revenues, "growth rate," "cash flow," and stock price. Moreover, defendant Scrushy did not disclose that he had already determined to sell more than 5,200,000 shares of HealthSouth within the next two weeks.

678. On May 9, 2002 HealthSouth announced that the U.S. Department of Justice had served it with a notice withdrawing its notice of partial intervention in a civil False Claims Act case against the Company. Scrushy asserted HealthSouth's practices were "appropriate" and the government's claims "meritless."

679. The numerous misrepresentations by defendants continued to cause securities analysts to recommend the purchase of HealthSouth shares. For example, in a report dated May 20, 2002 (one day before defendant Scrushy sold more than 5,200,000 shares), Lehman Brothers issued a "Strong Buy" on HealthSouth shares and set a "target" price of \$22 per share. Lehman Brothers advised its clients that HealthSouth shares represented "an attractive risk/reward scenario analysis with little downside from current levels (which we would peg in the \$11-\$12 range), in our view, and solid upside potential for possibly a 40-50%+ return if the shares reach the \$19-\$22 level which we have determined as fair value."

680. On May 14, 2002, Scrushy exercised options to purchase 5,275,360 shares of HealthSouth common stock.<sup>15</sup> Scrushy sold these shares the same day when the average of the high and low prices of HealthSouth common stock was \$14.03 per share, indicating the sale proceeds of approximately \$74,013,300, and net proceeds of approximately \$54,059,251.

681. Also on May 14, HealthSouth issued a press release disclosing the foregoing stock sale by defendant Scrushy and representing that he had “no intention of selling additional shares in the near future.” Additionally, in addressing the sales during his Investor Day presentation, Scrushy stated that he planned to use the proceeds of the sales to pay down a loan from the Company. The foregoing disclosures were materially false and incomplete because, at the time, defendant Scrushy was negotiating to repay, with additional HealthSouth shares, a \$25 million loan owed to HealthSouth.

682. On June 7 and 11, 2002, George H. Strong (“Strong”), a Director of HealthSouth and Chairman of the Audit Committee, sold (for his personal account or through trusts he had established) 52,125 HealthSouth shares at \$13.78 per share and 17,216 shares at \$14.28 per share, respectively, for total proceeds exceeding \$900,000. Additionally, on February 13-15, 2002, Strong had sold or disposed of an aggregate of 46,525 shares for proceeds exceeding \$550,000. Strong’s sales during the Class Period resulted in total proceeds exceeding \$1,500,000.

683. On June 11, 2002, defendant Owens was a featured speaker at a breakfast in New York on HealthSouth for investors and analysts hosted by Lehman Brothers. During the presentation, Owens continued to portray a rosy outlook for HealthSouth.

684. Following that upbeat presentation by defendant Owens, Lehman Brothers issued a report dated June 12, 2002 reiterating a “Strong Buy” recommendation on HealthSouth shares. After

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<sup>15</sup> These represented options with exercise prices of \$2.7825 per share, for an aggregate exercise price of \$19,954,049.

summarizing the positive statements by Owens and his subordinate, Lehman Brothers concluded: “We still highlight an attractive risk/reward scenario analysis with little downside risk from current levels (which we would peg in the \$11-\$12 range), in our view, and solid upside potential for possibly a 40-50%+ return if the shares reach the \$19-\$22 level which we have determined as fair value. Thus, we continue to recommend purchase of the shares of HRC with a STRONG BUY rating.”

685. Defendant UBS also issued positive but false reports about HealthSouth during the Second Quarter 2002, as described in Appendix 6.

**Reasons Defendants’ Statements Issued During the Second Quarter of 2002 Were False and/or Misleading**

686. The statements identified above and in Appendices 2 and 6 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the company as detailed herein.

687. Defendants’ statements concerning their financial results were false and misleading and HealthSouth’s income for the six months ended June 30, 2002 was not \$337 million as reported, but actually only \$107 million. The income was overstated by \$230 million. The SARC reported that HealthSouth’s first quarter 2002 income, before taxes and minority interest, was overstated due to improper adjustments by \$76.33 million. The Company’s assets were misstated by billions of dollars. In June, 2002, Michael Vines, formerly employed in HealthSouth’s Asset management Department, sent an email to E&Y detailing various accounting improprieties at HealthSouth, including falsifying records recording the Company’s fixed assets. E&Y admits that it received the e-mail on July 1, 2002, and forwarded it to HealthSouth. E&Y now claims that it investigated and absolved HealthSouth, but it never contacted Vines to investigate his claims, instead relying on the denials of HealthSouth officials that the Company engaged in any wrongdoing. In fact, the

individuals issuing those denials have now admitted to engaging in the very conduct Vines described.

688. Defendant Scrushy's statements that defendants would comply with all Congressional and SEC standards was both false and ironic, given that defendants in fact had violated such rules for years. The claim that the audit and compensation committees were comprised solely of independent directors was false, overlooking defendants Sage-Givens' and Gordon's conflicts of interest, and omitting reference to the numerous conflicts possessed by HealthSouth directors over the years.

689. Defendants' projections concerning DSO's and capital expenditures were false and misleading, as they were premised on distorted and false financials that the speakers, including Smith and Owens, knew to be false at the time, as made clear in their plea bargains with the government.

**False and/or Misleading Statements Issued  
During the Third Quarter of 2002**

690. On July 11, 2002, HealthSouth issued a press release entitled "HealthSouth Confirms Guidance for 2002" (the "July 11 Press Release"), in which Scrushy was quoted as stating:

"We have had strong operating results through the first half of 2002.... While the current market instability has had an adverse effect on our stock price, the fundamentals of our business continue to be solid, and we remain confident in our guidance for the rest of the year."

691. On July 11, 2002, HealthSouth issued the July 11 Press Release, in which defendants proclaimed comfort with the consensus Wall Street earnings estimates for the remainder of 2002. At the time of the issuance of the July 11 Press Release, defendants were aware of the financial fraud. Defendants knew that the recent dissemination of Transmittal 1753 and the implementation of appropriate coding, billing and reimbursement procedures would have a material adverse impact on the Company's revenues and earnings. In addition, defendants Scrushy and Owens knew that the terms of a forthcoming sale of stock by Scrushy to the Company to satisfy an outstanding \$25 million loan had been finalized; and the transaction was scheduled to close at the end of July, with

the value of the shares to be calculated at their market price on the date of the closing. Accordingly, Scrushy and his subordinate Owens had every reason to attempt to maximize the market price of HealthSouth shares, in order to limit the number of shares Scrushy needed to sell to satisfy his outstanding loan obligation.

692. In a report dated July 12, 2002, Merrill Lynch raised its recommendation on HealthSouth shares from “Neutral” to a “Strong Buy,” basing its recommendation on the representations by defendants in the July 11 Press Release that “[management] knew of no reason for the recent decline in its stock price” and it remained “confident in our guidance for the rest of the year.”

693. A favorable analysis of HealthSouth and its shares also appeared in the July 29, 2002 edition of Barron’s, the weekly financial periodical (the “July 29 Article”). (That edition was first publicly disseminated on Saturday, July 27, 2002.) Based in large measure on discussions with defendant Scrushy and defendants’ false and misleading public statements, Barron’s told its readers in the July 29 Article that HealthSouth’s shares were poised to rise. Barron’s explained its reasoning as follows:

HealthSouth ... has been recklessly diagnosed in the past few months with some of the same management and accounting ills that have sapped the broader market’s vigor. The experience has cost the company more than half its market value, leaving its shares at a recent 7.66.

Yet HealthSouth is poised to heal itself by meeting its profit targets for the second quarter and the year, and by convincing Wall Street that its books are as clean as, yes, an operating room. As investors grow to appreciate the strength of the company’s markets, the fitness of its balance sheet and the false nature of the charges that have tarred HealthSouth, its limpid shares are apt to regain not just a pulse but the healthy glow they sported before suspicion clouded sense as the market’s driving force. Specifically, with just a modest revaluation, the stock could return at least to the mid-teens.

694. Defendants’ misrepresentations induced Barron’s to issue the materially false and misleading statements contained in the July 29 Article. In fact, HealthSouth was not poised to meet “its profit targets,” “its books [were not] as clean as an operating room,” the Company did not have a

“fit[] ... balance sheet”, and defendants did not disclose to Barron’s that compliance with the Government’s billing requirements would materially reduce HealthSouth’s earnings and revenues.

695. On August 1, 2002, defendant Scrushy completed his sale to the Company of 2,506,770 shares of HealthSouth stock at \$10.06 per share.

696. On August 7, 2002 HealthSouth announced Second Quarter 2002 operating results, as described in App. 2, including earnings per share of \$0.28, consistent with consensus Wall Street estimates, and an EBITDA margin of 29.8%.

697. The August 7 Press Release (see App. 2) was materially false and misleading in that revenues, earnings and margins reported in it were materially inflated through the financial fraud. Indeed, pretax earnings were inflated by \$230 million for the first six months of 2002. Moreover, the Company’s systematic upcoding of group therapy sessions to individual sessions and the other improper billing practices described herein further inflated the financial results. Defendants knew, or were reckless in not knowing, HealthSouth’s billing procedures were improper under long-established CMS coding and reimbursement policies.

698. Three days after the Company released its second quarter results of operations, a follow-up article appeared in the August 12, 2002 edition of Barron’s (first disseminated to the public on August 10). Barron’s reported the increase in HealthSouth’s stock price following the publication of the previous Barron’s article and HealthSouth’s release of second-quarter results:

Barron’s argued in a recent profile of HealthSouth (“Down, Not Out,” July 29) that these charges were misplaced or exaggerated and that the company’s shares represented a compelling opportunity to play an attractive part of the health-care business at a bargain price.

The shares began to recover thereafter, a trend that continued through last week, when the company’s second-quarter earnings report gave tangible evidence of progress on all fronts.

699. On August 8, 2002, Merrill stated that “[m]anagement took steps to increase investor confidence in the company’s financial reporting, which we view positively. Specifically,



management said they will sign the SEC statement certifying the accuracy of HRC's financial statements." This combined with "Q2 2002 ... EPS of \$0.28 ... up 34.0% versus \$0.21 posted in the prior year ... were in line with consensus expectations as well as our forecast."

700. On August 14, 2002, the Company filed with the SEC a Report on Form 8-K (the "Form 8-K") signed by Scrushy and Smith. The Form 8-K was made in response to SEC Order 4-460, requiring senior executives of nearly 1,000 publicly traded corporations to file sworn statements attesting to the accuracy of, among other public filings, their companies' most recent annual and quarterly reports. Pursuant to the requirement of Order 4-460, Scrushy and Smith each represented that HealthSouth's 2001 Form 10-K and 2002 Form 10-Qs did not misrepresent any material facts or omit to state material facts necessary to make the statements in the SEC reports not misleading in light of the circumstances under which they were made.

701. Once again, the analysts' response to HealthSouth's reported June 30, 2002 results and outlook for the rest of 2002 was overwhelmingly favorable. On August 7, 2002, Jefferies issued an analyst report entitled "HRC: Good Quarter In All Respects." The report reiterated a "Buy rating on shares of HealthSouth with a \$22 price target." The report stated, "[s]econd quarter operating EPS were in line with consensus at \$0.28 versus \$0.21 a year ago."

702. On that same day, Citi/Salomon issued an analyst report which reiterated a price target of \$19 per share based on "reported 2Q02 EPS of \$0.28, in-line with the Street consensus and a penny better than our estimate, and vs. \$0.24 (FASB 142 adjusted) in 2Q01 (+17%)."

703. On August 27, 2002, HealthSouth announced reduced earnings guidance and the purported impact of Transmittal 1753.

#### **Reasons Defendants' Statements Issued During the Third Quarter of 2002 Were False and/or Misleading**

704. The foregoing positive statements were based on the false assumption that the Company's third quarter earnings report and the numerous positive representations made by

defendants were accurate and complete. In fact, defendants had failed to disclose the ongoing fraud detailed herein.

705. The Company's financial results were artificially inflated by senior management on a quarterly basis as described. For example, for the six months ended June 30, 2002, income (before taxes and minority interests) was overstated by \$183 million. Rather than the reported income of \$340 million for the period, HealthSouth only earned \$157 million. Moreover, the Company's assets were overstated by \$2.7 billion, which included overstated cash of \$370 million and PPE inflated by \$1.0 billion. The SARC reported that HealthSouth's second quarter 2002 income, before taxes and minority interest, was overstated due to improper adjustments by \$109.59 million.

706. Defendants' repeated reassurances that the Company's fundamentals were strong and that the Company would meet its earnings targets for 2002 were lacking any reasonable basis. Defendants had known for years that the Company was not billing for outpatient individual and group physical and rehabilitation therapy in accordance with Medicare reimbursement regulations and policies; that the CMS directive set forth in Transmittal 1753, if complied with, would materially reduce the Company's revenues and earnings and increase its expenses going forward; and that substantial expense and disruption would be incurred retraining Company personnel and otherwise bringing the Company's billing practices and procedures into compliance with the long-standing applicable CMS rules and regulations.

707. The Form 8-K was materially false and misleading because it failed to disclose, among other adverse facts, that HealthSouth's financial statements inflated revenues and earnings on a quarterly basis by virtue of the financial fraud and defendants' upcoding and the other unlawful billing practices.

### **False and/or Misleading Statements Issued During the Fourth Quarter of 2002**

708. On September 19, 2002, HealthSouth was forced to admit that it was the target of an SEC investigation. As reported in the September 19, 2002 edition of The Wall Street Journal, the investigation is “focusing in part on accounting issues and trading in the company’s stock, a person familiar with the matter said.”

709. That same day, CNBC interviewed defendant Scrushy on its “Business Center” news television show. In that interview, co-anchor Ron Insana probed Scrushy as to why he did not know of the adverse impact that Transmittal 1753 would have on HealthSouth’s financial condition until August 15, which was well after he sold millions of dollars of stock. The following exchange between Mr. Insana and defendant Scrushy took place:

INSANA: Mr. Scrushy, you understand the environment in which you find yourself right now, in a broader context, I trust. You have officials from Enron going to Washington and either taking the 5th, or saying they did nothing wrong. You have officials from Tyco saying they did nothing wrong.... And there’s been fraud uncovered in a variety of different places, where all the executives have said they’ve done nothing wrong. Here you may have made a coincidental stock sale, two weeks, three weeks before your disclosed material information. You understand why people would be skeptical.

SCRUSHY: I understand. I fully understand. The environment has a lot to do with what we have gone through. But let’s take a look at the situation. We are not talking about anything in the past. ***We are not talking about any financial reporting, any misreporting, we are not talking about any restatement, like WorldCom and the others*** ... We have one of the highest profit margins of all healthcare companies in America. We are in the mid-20s. The next biggest competitor is 20. I mean, no one is near us in terms of profitability.

### **Reasons Defendants’ Statements Issued During the Fourth Quarter of 2002 Were False and/or Misleading**

710. The statements identified above and in Appendices 2 and 6 were false and misleading in that they failed to reveal and/or contradicted the true state of affairs at the company as detailed in this Complaint.

711. Defendants' statements concerning the Company's financial and operational results through Third Quarter 2002 were false and misleading. The SARC reported that HealthSouth's third quarter 2002 income, before taxes and minority interest, was overstated due to improper adjustments by \$49.31 million. Defendants continued to lie both expressly and by omission in failing to acknowledge the massive fraud perpetrated on HealthSouth shareholders as set forth in detail in this Complaint. It took criminal indictments to bring this fraud to light.

712. On October 16, 2002, HealthSouth announced that it was suspending the planned spinoff of its surgery center division. In a cryptic explanation, defendant Scrushy stated: "Based on comments we have received from some of our investors and lenders and conditions in the debt and equity markets, we have determined that it does not make economic sense at this time to proceed with" the transaction.

713. On November 5, 2002, HealthSouth announced its Third Quarter 2002 results, as described in App. 2, including operating earnings of \$259.7 million.

714. On November 5, 2002, HealthSouth held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders. During the call Scrushy, Owens and McVay stated:

RICHARD SCRUSHY: I would like to begin by stating the third quarter was a challenging quarter for the company. The introduction of Transmittal 1753 certainly had an impact on the company. We had the negative press, a lot of bad press on the company which created some problems for us in terms of referrals. So we took a hit in that particular area.

The revenue increased by about 3%, that is excluding divestitures versus third quarter of last year. The impact really where we were hurt the most was in the outpatient area. We had a 14% reduction in volume resulting in about a 17% reduction in revenue decline. This of course was due to lower reimbursement, the Transmittal 1753 impact. That shows up in the pricing and Bill Owens will talk about that in a moment, which is about an 11% reduction in pricing.

So, you had 14% reduction in volume driving a 17% reduction in revenue in that particular area. But there is a lot of good news that we are going to talk about as well in other divisions. We will walk through that in a moment and go through all the statistics.

As we had a lower revenue number we had an increase in our AR days but if we are able to keep those revenues flat we would have shown only a very slight increase. We had about an \$18.5 million increase in AR, so our reduction, if we hadn't had -- without the reduction in revenue, we would have had about an 80.5 days in AR, but with the reduction it actually drove it up to 86.5.

\* \* \*

WILLIAM OWENS: Going productline by product line and talking about the issues that we have faced there. In out-patient rehabs very-well publicized the challenges that we faced in out-patient rehab. Transmittal 1753 resulted in a \$23 million revenue hit just simply from pricing, with a drop from the previous quarter of \$100 per visit, down to \$89 per visit.

## **THE TRUTH EMERGES**

### **The Government Commences a Criminal Investigation**

715. On February 6, 2003, HealthSouth issued a press release announcing that it had received a subpoena from the United States Attorney's Office for the this District seeking production of various documents. The Company further stated that "the types of documents requested suggest that the investigation may focus on transactions by individuals in HealthSouth common stock."

716. That same day the FBI confirmed that it had opened a criminal investigation into "possible securities laws violations" at the Company. The FBI spokesman further said that the FBI had conducted a series of interviews of HealthSouth executives over the prior two days in connection with the investigation, but declined to disclose any particulars.

717. On February 26, 2003, HealthSouth issued a press release (the "February 26 Press Release") in response to a "number of news media" reports on the SEC investigation. In the February 26 Press Release, the Company confirmed that the SEC had commenced a formal investigation regarding potential violations of the federal securities laws.

### **The Ratings Downgrades and Other Adverse Business Developments**

718. Following the announcement of the SEC investigation, S&P slashed its ratings on HealthSouth bonds to junk status and said it might lower the ratings even further. Specifically, S&P lowered HealthSouth senior unsecured debt two notches to "BB", its second-highest junk grade,

from “BBB-”. The Company had approximately \$3.3 billion of debt at the end of June. As further disclosed in the financial press, a downgrade raises HealthSouth’s borrowing costs. In response to the foregoing additional adverse disclosures and others concerning HealthSouth and its executives, Company shares declined to the \$3.00 per share range.

719. Also on March 3, 2003, HealthSouth hosted a conference call for investors and securities analysts in which defendants Scrushy and Owens were the principal Company spokespersons. Once again, Scrushy falsely placed the blame on compliance with Transmittal 1753. Indeed, he began the presentation “by stating that 2002 was a very difficult year for our company ... due to Transmittal 1753....” During the call Scrushy, McVay and Owens stated:

SCRUSHY: So we want to reiterate that the EPS guidance of \$.55 for 2003 still looks like a very good number for us.

\* \* \*

McVAY: We are projecting for the first quarter of 2003 EBITDA should come in the range of \$253 million. We would then expect a sequential ramp-up to end the year in compliance with our guidance, which would be EBITDA between \$1,055,000,000 and \$1,060,000,000 for the year.

BILL OWENS: There are two components of the AR charge. First, on the retros, which was \$65.8 million, and that all relates to in-patient rehab. That is simply a change in estimates. We have a model internally that estimates cost our report settlements for internal projections, and those cost reports don’t get filed for 9 to 10 months later, and each year during cost reimbursement, we have estimated and adjusted down to actual filings, and our model was such that those work themselves out every year between the true-up of the prior years and the estimate of the current year.

However, this year, with going off of cost-based reimbursement and filing all of the final cost reports, there is no true-up in the current year of the model, so everything that is out there has just fallen out.

It is not an evaluation of AR – it is our open cost reports and what we expect to announce based on all the information we have after having filed all those final cost reports, the reimbursement that we will receive on those.

It is not a matter of valuing individual accounts that were over 365 days old – it is settlements on cost reports that date for several open periods, not only terminating cost reports, but other open cost reports, that are still out there being settled.

That information being booked in the fourth quarter, we did not get all of our cost reports filed until very late in the year, and the information, and this year was a year in which the forms and the reports were not available until late. We filed them all by the deadlines, and that information, pulling all those together, was not available to us in the fourth quarter, so it's properly booked as a change in estimate in the quarter in which the information was available to us.

On the AR charge of \$110 million, we go through a detailed analysis at the end of every year as part of our audit. It is a standard process we have been through year after year. This year, when we went through that process at the end of the year, it showed that based on the information available to us that our reserves appeared to be under to the tune of around \$100 million. As we researched that and went back and we applied these procedures that we always apply at the end of every quarter, which are analytical procedures that did not drive us to do more detailed work, and we went back and did the detail work, it revealed that this is truly a fourth quarter issue, and our reserves had dropped significantly in the fourth quarter, driven primarily by increased collection so that we are very comfortable and Ernst & Young has done the work, to be very comfortable, that this is a change in estimate. The reality is that based on the information we now have available to us, we realize that the valuation of some of our older accounts was not conservative enough, and we are upping that valuation, and it is properly booked in the fourth quarter, because that is the quarter in which the changes in the reserves occurred, and the information based on enhanced collections, better systems, have made available to us.

**Reasons Defendants' Statements Re: the  
Criminal Investigation Were False and/or Misleading**

720. The foregoing statements relating to HealthSouth's financial and operational results were false and/or misleading.

721. Defendants lied by omission in failing to acknowledge the massive fraud on which all of HealthSouth's financial and operational results were based. They overtly lied by continuing to tout reasons which were based on previous quarters' fraudulent results.

722. The statements about the effects of Transmittal 1753 on HealthSouth were materially false, as further shown by the testimony of Martin Cohen before the E&C Committee on October 16, 2003. See App. 14.

723. Even after being forced to acknowledge that the SEC and the U.S. Attorney's Office were investigating, defendants still refused to come clean. Instead, defendants continued to tout

projections that would end the year consistent with previous guidance, and blamed Transmittal 1753 for their problems.

724. Defendants' representations were materially false and misleading in failing to disclose that the 2002 financial results were inflated as a result of the financial fraud and the Overbilling Fraud. Moreover, their statements were materially misleading in claiming that hundreds of millions of dollars in charges against earnings incurred by HealthSouth in the fourth quarter of 2002 had resulted from Transmittal 1753 when, in fact, defendants knew or recklessly disregarded that the charges were due in large part to reversing the effects of the Financial Fraud – which had inflated revenues and earnings for many years.

#### **The SEC Actions and Criminal Cases**

725. On March 19, 2003, the truth about defendants' financial fraud began to emerge with the filing of the SEC Actions and Smith's guilty plea. The SEC suspended trading in HealthSouth stock which had closed at \$3.91 on March 18, 2003.

726. On March 20, 2003, the Court issued a temporary freeze on substantially all of Scrushy's assets. Defendants Scrushy and Owens were placed on "administrative leave," and were later fired. The Company's auditors, E&Y, were also removed, and PricewaterhouseCoopers was hired to determine the actual state of HealthSouth's financial condition and value. On April 1, 2003, HealthSouth announced that it was unable to file its annual report on Form 10-K for the year ended December 31, 2002 in light of the foregoing proceedings, and the Company postponed its 2002 annual meeting of stockholders, originally scheduled for May 15, 2003.

727. On March 24, 2003, HealthSouth publicly stated that its financial statements should not be relied upon in light of the SEC Actions and DOJ criminal investigation. On March 25 and 31, 2003, Owens and Harris, respectively, pled guilty to the criminal charges of securities fraud. In a separate court filing on March 25, the SEC represented that Scrushy "appears to have testified



untruthfully” at his March 14, 2003 deposition, in which he adamantly denied instructing HealthSouth employees to change the Company’s financial results.

728. Moreover, the Company’s lending banks, led by J. P. Morgan Chase, declared a “default” and froze the Company’s \$1.25 billion line of credit. HealthSouth also defaulted on the payment of \$350 million in outstanding convertible notes which matured on April 1, 2003. S&P has again reduced HealthSouth’s credit rating to “CCC-.”

729. On April 1, 2003, HealthSouth’s insurers, Chubb Corp., Federal Insurance Co., and Executive Risk Indemnity, Inc., announced that they had commenced an action in Delaware Superior Court to rescind all insurance policies issued or renewed since September 1998, based on fraud.

730. The market price of the Company’s stock, which traded as high as \$31 per share during the Class Period, collapsed to the range of \$0.08 to \$0.11 per share.

### **LEGAL THEORIES AND CLAIMS**

731. Pursuant to the Court’s June 24, 2003 Order, the Stockholder and Bond Classes, and the Merger Subclasses, have set forth, in separate documents, their respective legal theories, claims and prayers for relief.

Plaintiffs demand a jury trial as to all issues so triable.

Dated: August 2, 2004

#### FOR THE STOCKHOLDER CLASS

WHATLEY DRAKE, LLC  
JOE R. WHATLEY, JR.  
RUSSELL JACKSON DRAKE  
G. DOUGLAS JONES (ASB-3880-S82G)

/s/ G. Douglas Jones  
\_\_\_\_\_  
G. DOUGLAS JONES

#### FOR THE BONDHOLDER CLASS

DONALDSON & GUIN, L.L.C.  
DAVID J. GUIN (ASB-3461-G67D)  
DAVID R. DONALDSON  
TAMMY McCLENDON STOKES

/s/ David J. Guin  
\_\_\_\_\_  
DAVID J. GUIN

2323 Second Avenue North  
Birmingham, AL 35202  
Telephone: 205/328-9576  
205/328-9669 (fax)

*Liaison Counsel for Stockholder Class*

LERACH COUGHLIN STOIA  
& ROBBINS LLP  
WILLIAM S. LERACH  
EDWARD P. DIETRICH  
KATHLEEN A. HERKENHOFF  
DEBRA J. WYMAN  
VALERIE L. McLAUGHLIN  
ELIZABETH J. ARLEO  
ERIN P. McDANIEL  
401 B Street, Suite 1700  
San Diego, CA 92101  
Telephone: 619/231-1058  
619/231-7423 (fax)

LERACH COUGHLIN STOIA  
& ROBBINS LLP  
PATRICK J. COUGHLIN  
LESLEY E. WEAVER

---

/s/ Patrick J. Coughlin  
PATRICK J. COUGHLIN

100 Pine Street, Suite 2600  
San Francisco, CA 94111  
Telephone: 415/288-4545  
415/288-4534 (fax)

- and -

Two North Twentieth Street, Suite 1100  
Birmingham, AL 35223  
Telephone: 205/226-2282  
205/226-2357 (fax)

*Liaison Counsel for Bondholder Class*

BERNSTEIN LITOWITZ BERGER &  
GROSSMANN LLP  
MAX W. BERGER  
JOHN P. COFFEY  
JEFFREY N. LEIBELL  
JENNIFER L. EDLIND

---

/s/ John P. Coffey  
JOHN P. COFFEY

1285 Avenue of the Americas, 38th Floor  
New York, NY 10019  
Telephone: 212/554-1400  
212/554-1444 (fax)

- and -

LOWEY DANNENBERG BEMPORAD  
& SELINGER, P.C.  
NEIL L. SELINGER  
RICHARD BEMPORAD  
THOMAS SKELTON  
VINCENT BRIGANTI  
The Gateway – 11th Floor  
One North Lexington Avenue  
White Plains, NY 10601  
Telephone: 914/997-0500  
914/997-0035 (fax)

*Co-Lead Counsel for Stockholder Class and  
the Additional Stockholder Named Plaintiffs*

FOR NSC & TCD STOCKHOLDERS  
SUBCLASS

SCHATZ & NOBEL, P.C.  
ANDREW M. SCHATZ  
One Corporate Center  
20 Church Street, Suite 1700  
Hartford, CT 06103  
Telephone: 860/493-6292  
860/493-6290 (fax)

FOR HORIZON STOCKHOLDER SUBCLASS

LAW OFFICES OF M. CLAY RAGSDALE  
M. CLAY RAGSDALE  
1929 Third Avenue North, Suite 550  
Birmingham, AL 35203  
Telephone: 205/251-4775  
205/251-4777 (fax)

CUNNINGHAM BOUNDS YANCE  
CROWDER & BROWN  
JOHN T. CROWDER  
ROBERT T. CUNNINGHAM, JR.  
RICHARD T. DORMAN  
P.O. Box 66705  
Mobile, AL 36660  
Telephone: 251/471-6191  
251/479-1031 (fax)

*Co-Lead Counsel for Bondholder Class*

ADDITIONAL NAMED BONDHOLDER  
PLAINTIFF'S COUNSEL

BERMAN DeVALERIO PEASE TABACCO  
BURT & PUCILLO  
MICHAEL J. PUCILLO  
515 North Flagler Drive, Suite 1701  
W. Palm Beach, FL 33401  
Telephone: 561/835-9400  
561/835-0322 (fax)

*Attorneys for Additional Named Bondholder  
Plaintiff State Universities Retirement System  
of Illinois*

## DECLARATION OF SERVICE

I hereby certify that on this 2nd day of August, 2004, a copy of the foregoing JOINT SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS [FACTUAL BASIS] was served by electronic means, except as otherwise noted, pursuant to the Court's January 6, 2004 electronic service order, and addressed to the attorneys listed on the attached Appendix G and Service by Mail list.

/s/ G. Douglas Jones  
G. Douglas Jones, Of Counsel

## APPENDIX G

### IN RE HEALTHSOUTH CORP. SECURITIES LITIGATION [Master File No. CV-03-BE-1500-S]

<b><u>Party</u></b>	<b><u>Name of Person to Serve</u></b>	<b><u>Email Address</u></b>
Stockholder Plaintiffs		
	Edward Dietrich	<a href="mailto:edd@lcsr.com">edd@lcsr.com</a>
	Kathleen Herkenhoff	<a href="mailto:kathyh@lcsr.com">kathyh@lcsr.com</a>
	Debra Wyman	<a href="mailto:debraw@lcsr.com">debraw@lcsr.com</a>
	Elizabeth Arleo	<a href="mailto:ELIZA@lcsr.com">ELIZA@lcsr.com</a>
	Jill De Carvalho	<a href="mailto:JILLDC@lcsr.com">JILLDC@lcsr.com</a>
	Valerie McLaughlin	<a href="mailto:valeriem@lcsr.com">valeriem@lcsr.com</a>
	Lesley E. Weaver	<a href="mailto:lesleyw@lcsr.com">lesleyw@lcsr.com</a>
	Erin McDaniel	<a href="mailto:erinm@lcsr.com">erinm@lcsr.com</a>
	Neil Selinger	<a href="mailto:NSelinger@ldbs.com">NSelinger@ldbs.com</a>
	G. Douglas Jones	<a href="mailto:djones@whatleydrake.com">djones@whatleydrake.com</a>
	Chianne Sanchez (DJ asst)	<a href="mailto:csanchez@whatleydrake.com">csanchez@whatleydrake.com</a>
Merger Plaintiffs		
Horizon/CMS Stockholders	M. Clay Ragsdale	<a href="mailto:clay@ragsdalefrese.com">clay@ragsdalefrese.com</a>
NSC Stockholders	Andrew M. Schatz	<a href="mailto:sn06106@aol.com">sn06106@aol.com</a> ; <a href="mailto:aschatz@snlaw.net">aschatz@snlaw.net</a>
Bondholder Plaintiffs		
	Max Berger	<a href="mailto:max@blbglaw.com">max@blbglaw.com</a>
	John P. Coffey	<a href="mailto:sean@blbglaw.com">sean@blbglaw.com</a>
	Jeffrey N. Leibell	<a href="mailto:jeffl@blbglaw.com">jeffl@blbglaw.com</a>
	Jennifer Edlind	<a href="mailto:jenn@blbglaw.com">jenn@blbglaw.com</a>
	Eric T. Kanefsky	<a href="mailto:erick@blbglaw.com">erick@blbglaw.com</a>

	Robert Cunningham	rtc@cbycb.com
	John T. Crowder	jtc@cbycb.com
	Richard Dorman	rtd@cbycb.com
	Edwin Lamberth	rel@cbycb.com
	David J. Guin	davidg@dglawfirm.com
	Tammy M. Stokes	tstokes@dglawfirm.com
HealthSouth Corporation		
	Edward P. Welch	<a href="mailto:ewelch@skadden.com">ewelch@skadden.com</a>
	Stephen Dargitz	<a href="mailto:sdargitz@skadden.com">sdargitz@skadden.com</a>
	J. Michael Rediker	jmr@hsy.com
	Michael K.K. Choy	mkc@hsy.com
	Lisa M. Rios	lmr@hsy.com
	David Anderson	<a href="mailto:danderson@walstonwells.com">danderson@walstonwells.com</a>
	Julia Boaz Cooper	<a href="mailto:jbcooper@walstonwells.com">jbcooper@walstonwells.com</a>
Defendants Chamberlin, Givens, Gordon, Hanson, May, Newhall, Striplin and Strong	J. Mark Hart	jmh@hsy.com
	Paul C. Gluckow	pgluckow@stblaw.com
	Allison R. Kimmel	akimmel@stblaw.com
Defendant Anthony Tanner	Jackson R. Sharman, III	jsharman@lflaw.com
	Jim Hughey	jhughey@lflaw.com
Defendant Russell H. Maddox	C. Lee Reeves	<a href="mailto:lreeves@sirote.com">lreeves@sirote.com</a>

Defendant Edwin M. Crawford	W. Michael Atchison	WMA@starneslaw.com
	Anthony C. Harlow	ACH@starneslaw.com
Outside Directors/ Current Officers/ Unindicted Individual Defendants	N. Lee Cooper	<a href="mailto:lcooper@mcglaw.com">lcooper@mcglaw.com</a>
	Jim Goyer	<a href="mailto:jgoyer@mcglaw.com">jgoyer@mcglaw.com</a>
	Jim Bussian	<a href="mailto:jbussian@mcglaw.com">jbussian@mcglaw.com</a>
	Carl Burkhalter	<a href="mailto:cburkhalter@mcglaw.com">cburkhalter@mcglaw.com</a>
	Scott Brown	<a href="mailto:scottbrown@mcglaw.com">scottbrown@mcglaw.com</a>
	Amye Carle (paralegal)	<a href="mailto:acarle@mcglaw.com">acarle@mcglaw.com</a>
	Peter Bassett	<a href="mailto:pbassett@alston.com">pbassett@alston.com</a>
	Betsy Collins	<a href="mailto:bcollins@alston.com">bcollins@alston.com</a>
	Susan Hurd	<a href="mailto:shurd@alston.com">shurd@alston.com</a>
	Patrick Cooper	pcooper@mcglaw.com
Former Director Larry R. House	N. Lee Cooper	<a href="mailto:lcooper@mcglaw.com">lcooper@mcglaw.com</a>
	Patrick C. Cooper	<a href="mailto:pcooper@mcglaw.com">pcooper@mcglaw.com</a>
	Carl S. Burkhalter	<a href="mailto:cburkhalter@mcglaw.com">cburkhalter@mcglaw.com</a>
	Scott S. Brown	<a href="mailto:scottbrown@mcglaw.com">scottbrown@mcglaw.com</a>
Individual Defendant James Bennett	Don Long	<a href="mailto:dbl@jbpp.com">dbl@jbpp.com</a>
	Juile Cadden (DL asst.)	<a href="mailto:jac@jbpp.com">jac@jbpp.com</a>
	Jim Henry	<a href="mailto:jfh@jbpp.com">jfh@jbpp.com</a>
	Alan Mathis	<a href="mailto:adm@jbpp.com">adm@jbpp.com</a>
Defendant Thomas W. Carman	Joseph A. Fawal	<a href="mailto:jfawal@bellsouth.net">jfawal@bellsouth.net</a>

Richard M. Scrushy		
	Thomas Sjoblom	tsjoblom@chadbourn.com
	Scott Balber	sbalber@chadbourn.com
	Thomas Hall	thall@chadbourn.com
	H. Lewis Gillis	hlgillis@tmgpc.com
	April D. Williams	<a href="mailto:adwilliams@tmgpc.com">adwilliams@tmgpc.com</a>
	Gary H. Baise	<a href="mailto:gbaise@baisemiller.com">gbaise@baisemiller.com</a>
	Donald V. Watkins	donaladvatkins@aol.com
Pleading Defendants		
Kenneth Livesay	Joseph A. Fawal	jfawal@bellsouth.net
Michael D. Martin	C. Lee Reeves	lreeves@sirote.com
Michael D. Martin	Robert Fleishman	rfleishman@steptoe.com
Weston Smith and Susan Smith (Jones)	Charles A. Dauphin	<a href="mailto:cdauphin1@cs.com">cdauphin1@cs.com</a>
Tad McVay	J. Donald Foster	jdf@jacksonfosterlaw.com
Angela Ayers	Henry I. Frohsin	hfrohsin@bakerdonelson.com
Cathy Edwards	James L. O'Kelley	jlokelley@lawyer.com
Virginia Valentine	Erskine R. Mathis	erskinelaw@aol.com
Emery Harris	Pro se	(unknown) <u>Physical address is:</u> 2009 Eagle Crest Court Birmingham, AL 35242
Rebecca Kay Morgan	Stephen A. Strickland	stephen@rjaffelaw.com
Aaron Beam	Jeremy Hazelton	JHazelton@briskman-binion.com
Aaron Beam	Mack B. Binion, III	mbinion@briskman-binion.com
William T. Owens	Frederick G. Helmsing	fgh@helmsinglaw.com
	Patrick Finnegan	<a href="mailto:pcf@helmsinglaw.com">pcf@helmsinglaw.com</a>
	Carolyn Reid	<a href="mailto:cer@helmsinglaw.com">cer@helmsinglaw.com</a>



	Joy Rhodes Brewer	mjb@helmsinglaw.com
Defendant Catherine Fowler	Leon Ashford	<a href="mailto:leon@hwnn.com">leon@hwnn.com</a>
Defendant Will Hicks	Teresa Tanner Pulliam	<a href="mailto:ttpulliam@msn.com">ttpulliam@msn.com</a>
Ernst & Young	Henry Simpson	henry.simpson@arlaw.com
	Steven M. Farina	sfarina@wc.com
Investment Bank Defendants		
	W. Stancil Starnes	sstarnes@starneslaw.com
	Jay M. Ezelle	<a href="mailto:jme@starneslaw.com">jme@starneslaw.com</a>
	Robin Houston Jones	<a href="mailto:rhj@starneslaw.com">rhj@starneslaw.com</a>
<i>(All except UBS Entities)</i>	Carmine D. Boccuzzi	cboccuzzi@cgsh.com
	Mitchell A. Lowenthal	mloenthal@cgsh.com
	Stephen T. Ostrowski	<a href="mailto:sostrowski@cgsh.com">sostrowski@cgsh.com</a>
	Jeffrey Jordan	<a href="mailto:jjordan@cgsh.com">jjordan@cgsh.com</a>
	Michael McIntyre	<a href="mailto:mmcintyre@cgsh.com">mmcintyre@cgsh.com</a>
	Richard V. Conza	<a href="mailto:rconza@cgsh.com">rconza@cgsh.com</a>
	Nancy I. Ruskin	<a href="mailto:nruskin@cgsh.com">nruskin@cgsh.com</a>
<i>(UBS Entities only)</i>	Robert J. Giuffra	<a href="mailto:giuffrar@sullcrom.com">giuffrar@sullcrom.com</a>
	Thomas L. Leuba	<a href="mailto:leubat@sullcrom.com">leubat@sullcrom.com</a>
	Julia M. Jordan	<a href="mailto:jordanjm@sullcrom.com">jordanjm@sullcrom.com</a>
Defendant William McGahan	Helen A. Gredd	<a href="mailto:hgredd@lswlaw.com">hgredd@lswlaw.com</a>
	W. Stancil Starnes	sstarnes@starneslaw.com
	Jay M. Ezelle	<a href="mailto:jme@starneslaw.com">jme@starneslaw.com</a>

	Robin Houston Jones	<a href="mailto:rhj@starneslaw.com">rhj@starneslaw.com</a>
Defendant Howard Capek	Thomas Fitzpatrick	<a href="mailto:TFitzpatrick@TFitzpatrick.com">TFitzpatrick@TFitzpatrick.com</a>
	W. Stancil Starnes	<a href="mailto:ssarnes@starneslaw.com">ssarnes@starneslaw.com</a>
	Jay M. Ezelle	<a href="mailto:jme@starneslaw.com">jme@starneslaw.com</a>
	Robin Houston Jones	<a href="mailto:rhj@starneslaw.com">rhj@starneslaw.com</a>

**SERVICE BY MAIL**  
***In re HealthSouth Sec. Litig.***  
**Master File No. CV-03-BE-1500-S**

Served by first-class U.S. Mail:

Jason Brown, Pro Se  
652 Paden Drive  
Birmingham, AL 35226

Emery Harris, Pro Se  
2009 Eagle Crest Court  
Birmingham, AL 35242

Bruce Rogers  
Bainbridge Mims Rogers & Smith  
P.O. Box 530886  
Birmingham, AL 35253

Kenneth O. Simon  
Christian & Small LLP  
505 North 20th Street, Suite 1800  
Birmingham, AL 35203-2696

Daniel A. Angelo  
Green Buckley Jones & McQueen  
2970 Clairmont Road, Suite 1010  
Atlanta, GA 30329

William P. Hammer, Jr.  
Ernst & Young LLP  
5 Times Square, 36th Floor  
New York, NY 10036

Richard H. Deane, Jr.  
Jones Day  
3500 SunTrust Plaza  
303 Peachtree Street, N.E.  
Atlanta, GA 30308-3242

Robert F. McDermott, Jr.  
Jonathan Rose  
Jones Day  
51 Louisiana Avenue, N.W.  
Washington, DC 20001-2113

Law Offices of Teresa Tanner Pulliam  
2229 1st Avenue North  
The Black Diamond Building  
Birmingham, AL 35203